Communications

Update on The Federal Taxation of Annuities: A Success Story

To the Editor:

The purpose of this letter is to provide a brief update to my article. The Federal Taxation of Annuities: A Success Story published in the May 1995 issue of this Journal. In my article, I mentioned that some banks recently have begun offering arrangements which they claim should be treated as deferred annuities for Federal income tax purposes. As mentioned in the article, if a contract is both a "debt instrument" and an annuity contract issued by other than an insurance company, it is subject to taxation as a debt instrument under the original issue discount ("OID") provisions of the Internal Revenue Code (the "Code"), rather than as an annuity contract under section 72 of the Code, unless it qualifies for the annuity exception to the OID provisions set forth in Code section 1275(a)(1)(B)(i).

In this connection, the article considered one such bank arrangement marketed under the name Retirement CD and stated generally that, in my opinion, a bank-issued "annuity" like the Retirement CD does not qualify for the section 1275(a)(1)(B)(i) annuity exception, and thus is not an annuity for tax purposes, at least prior to its maturity. I concluded that, at least during the deferral stage prior to maturity, such a bank-issued arrangement should be taxable as a debt instrument under the OID provisions. At the time the article went to press, there was no clear guidance on this issue, and I indicated that it would be valuable for the Internal Revenue Service to publish such guidance.

On April 7, 1995, the Internal Revenue Service issued proposed regulations stating that an annuity contract issued by other than an insurance company will satisfy the section 1275(a)(1)(B)(i) annuity exception, and thus will not be treated as a debt instrument under the OID rules:

only if all payments under the contract are periodic payments that —

(A) are made at least annually for the life (or lives) of one or more individuals:

(B) do not increase at any time during the term of the contract; and

(C) are part of a series of payments that begins within one year of the date of the initial investment in the contract. Prop. Treas. Reg. section 1.1275-1(d)(2)(i).

The requirement that all payments under the contract be periodic payments operates to prevent a contract with a commutation right or surrender right from qualifying for this exception.

The requirement that payments must begin within one year of the initial investment precludes a deferred annuity issued by other than an insurance company from satisfying the proposed regulations. In this connection, the rule that payments cannot increase at any time during the term of the contract prevents a contract that is in substance a deferred annuity from avoiding the proposed regulations by providing a pattern of very smallpayments beginning within one year from the initial investment, followed by a series of much higher payments beginning more than one year from that investment.

In addition, the proposed regulations provide that an annuity issued by a noninsurer does not fail to qualify for the section 1275(a)(1)(B)(i) annuity exception merely because it provides for a payment (or payments) made by reason of the death of one or more individuals. See Prop. Treas. Reg. 1.1275-1(d)(2)(ii). While it is not entirely clear from the face of the proposed regulations, it does not appear that a contract providing payments for life with guaranteed payments for a certain period, e.g., 10 years, would satisfy the proposed regulations. The reason for this is that payments for the stated period are guaranteed in all events, and thus are not made by reason of the death of one or more individuals. Perhaps the final regulations will clarify this issue.

The preamble to the proposed regulations states that they do not apply to an annuity contract issued by other than an insurance company which is not a debt instrument. The preamble indicates that an annuity will be considered a debt instrument for this purpose if it provides for a "guaranteed return." It appears that an annuity contract without a surrender or commutation right, guaranteed maturity value, or guaranteed payment stream would not provide a guaranteed return, and thus would not be a debt instrument subject to the proposed regulations. The preamble states, "(f)or example, that an annuity contract under which payments are wholly contingent on the continued life of an individual generally is not a debt instrument for federal income tax purposes." It should be noted, however, that the preamble provides further that an annuity without a guaranteed return will nevertheless be considered a debt instrument for this purpose if a return is guaranteed by another instrument (e.g., where an annuity that is not a debt instrument is issued in combination with a life insurance contract that, together, effectively provide for a guaranteed return).

The proposed regulations are effective for annuity contracts which are held on or after the date that is 30 days after the final regulations are published in the Federal Register. Also, the proposed regulations do not apply to annuity contracts purchased prior to April 7, 1995 (i.e., the date the proposed regulations were published in the Federal Register), but do apply to any additional investment in a contract made on or after that date, unless the investment is required under a binding contractual obligation entered into prior to that date. See Prop. Treas. Reg. 1.1275-1(d)(2)(iii).

In short, the proposed regulations do not apply to an annuity contract issued by other than an insurance company which is (1) purchased prior to April 7, 1995 (assuming no additional premiums are paid after that date), or (2) purchased prior to the effective date of the final regulations but which is not held on that date.

A public hearing on the proposed regulations has been scheduled for August 8, 1995, at the National Office of theInternal Revenue Service in Washington, D.C. Hence, there is more to come regarding the application of the annuity exception under Code section 1275(a)(1)(B)(i) to "annuities" issued by other than insurance companies.

I hope that your readers find this update helpful.

Mark E. Griffin
Davis & Harman
Washington, D.C.

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The Federal Income Taxation of Annuities: A Success Story

MARK E. GRIFFIN, J.D., LL.M.

Abstract: *The federal income tax treatment of annuities reflects the policy view that annuities are an important and effective means for individuals to accumulate savings to provide retirement income. This article examines the types of arrangements treated as annuities for tax purposes and briefly compares the tax treatment of annuities with that of certain other savings vehicles. The author believes that legislative fine-tuning over the years has sufficiently restricted the tax treatment of annuities to encourage saving for retirement, and he suggests that legislative action to restrict annuities further or to repeal their current tax treatment would be inappropriate and contrary to sound federal policy.*

Annuities are recognized as a unique and effective means for individuals to accumulate savings to provide for their own and their dependents' financial security. It is undisputed that annuities are one of the most important and effective means for low and middle income families, as well as elderly Americans, to accumulate personal savings to provide basic and supplemental retirement income. Frequently, low and middle income individuals have more pressing financial commitments than saving for retirement, such as purchasing a home and educating their children, and often are unable to focus on the need for retirement savings at early ages. The purchase of deferred annuities at later ages allows such individuals to "catch up" on their retirement savings.

Also, the income needs of elderly individuals vary widely and are often unpredictable. Annuities are unique in that they offer the option of receiving income for life, thereby protecting elderly individuals from outliving their assets. Moreover, annuities offer other options so individuals can save for all their retirement needs — a sudden illness or a need for institutional care can create a need for larger amounts of income for some period of time.

In addition to fostering retirement savings, annuities also promote savings for preretirement needs. For example, through an annuity, an individual can provide systematic income for the support of dependents unable to care for themselves, or for the education of his or her children. Furthermore, because annuities encourage long-term investment, life insurance companies issuing them have come to provide a unique source of long-term investment capital, which significantly contributes to the growth of jobs and the economy.

As a result of the proven value of annuities, federal tax policy has, for many years, encouraged savings through nonqualified annuities. Nevertheless, there have been a number of proposals over the last 15 years or so to change the federal income tax treatment of nonqualified annuities. Some of these proposals have dealt with the fundamental issue of what types of arrangements should be viewed as annuities, while others have dealt with collateral issues regarding the taxation of annuity benefits.

This article[1] examines the types of arrangements that are treated as annuities for federal income tax purposes and briefly compares the federal income tax treatment of annuities with certain other savings vehicles. The article then considers the reasons why various legislative proposals to reduce or eliminate the long-standing tax deferral treatment of nonqualified annuities have failed in the past and should continue to be rejected in the future.

What is an Annuity for Tax Purposes?

In general terms, an annuity contract is an insurance policy that promises the periodic payment of a sum of money for a term of years (a term certain annuity), for the life of an individual or the joint lives of several individuals (a life annuity), or both.[2] How an annuity is viewed, however, depends upon the context in which it is considered. For instance, annuities have been described differently for federal securities law, banking law, and tax law purposes.[3] The following discussion focuses on what constitutes an annuity for federal tax purposes.

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In General

Although the Internal Revenue Code (the Code) contains numerous references to an "annuity contract," that term is not directly defined in the statute. The legislative history of Section 72,[4] which is the principal Code provision governing the taxation of annuity contracts, is similarly silent. It states only that "[t]he rule [of Section 72] ... applies to payments for a fixed number of years as well as to payments for life."[5]

The regulations under Section 72 provide only limited guidance:

> The contracts under which amounts paid will be subject to the provisions of section 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For the purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company.[6]

Although the regulations make reference to annuities "in accordance with the customary practice of insurance companies," they do not elaborate on this concept. Moreover, the regulations state only that an annuity contract for purposes of Section 72 *includes* (but is not necessarily limited to) such contracts.

Congress has occasionally enumerated specific requirements that an arrangement must meet to be an annuity. For example, Section 72(s) states that a contract will not be treated as an annuity contract for federal tax purposes unless it provides for specified distributions in the event that the "holder" of the contract dies. Section 72(u) states that, with certain exceptions, a contract will not be treated as an annuity if it is held by a "non-natural" person.

In addition, Section 817(h) provides that for purposes of subchapter L (relating to the income tax treatment of life insurance companies), Section 72 (relating to the treatment of distributions from annuities, endowments and life insurance contracts), and Section 7702(a) (defining a life insurance contract), a variable contract will not be treated as an annuity, endowment, or life insurance contract for any period for which the investments made by the separate account on which the contract is based are not adequately diversified in accordance with regulations.

All of these provisions are framed in the negative, however. That is to say, while an arrangement that fails to meet the requirements of those sections will not be an annuity for at least certain federal tax purposes, an arrangement that does satisfy those sections is still not assured of treatment as an annuity. As a consequence, it has been left largely to the courts and the Internal Revenue Service (the Service) to determine which insurance instruments constitute annuity contracts taxable under Section 72. Over the years, the courts and the Service have addressed a number of features or elements that must be present (or absent) in a contract in order for it to constitute an annuity contract under Section 72. Three of the most critical elements are discussed below.

Provision for "Annuity Payments"

The statutory scheme in Section 72 recognizes that not all payments under an annuity contract must be in the form of annuity payments and that an annuity contract may provide for the payments of amounts in another manner. Nevertheless, it appears that the Service takes the position that in order for a contract to be an annuity contract, the issuer must be obligated to make fixed and determinable annuity payments. In the case of a deferred annuity contract that contains permanent, life-contingent purchase rate guarantees, i.e., the typical contract issued by a life insurance company, this requirement is clearly met.[7]

In this connection, deferred annuity contracts frequently specify that annuity payments must begin on or before a certain age of the annuitant.[8] Since an essential element of an annuity contract is the provision for annuity payments, a question may arise as to the character of a contract as an annuity if the contract establishes an annuitization date at so high an age that the possibility of receiving annuity payments appears remote or illusory.

In the past, the Service has raised the issue of whether an annuity contract was truly an annuity where periodic payments would not begin until the annuitant reached age 95.[9] On the other hand, the Service has treated a contract as an annuity contract where commencement of annuity payments could be delayed until the attainment of age 85.[10] Given increased longevity, later annuitization dates should be acceptable, but the outer limit for commencing annuity payments is unclear at this time.

Exhaustion of Investment and Income

Courts have stated that the essence of an annuity contract is the systematic liquidation of a fund, consisting of the investment in the contract and the earnings thereon.[11] A contract which does not provide for the systematic liquidation of investment and interest is not an annuity for tax purposes and may be characterized as a contract for the payment of interest. This distinction is set forth in Section 72(j), which states that "if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income." The regulations under that section state further:

> An amount shall be considered to be held under an agreement to pay interest thereon if the amount payable after the term of the annuity (whether for a term certain or

for a life or lives) is substantially equal to or larger than the aggregate amount of premiums or other consideration paid therefore.[12]

The issue of whether payments under a contract represent only interest payments should not arise simply because a contract contains a death benefit or other similar refund feature assuming eventual return of principal. On the other hand, if a contract guaranteed that the holder would recover his or her investment in the contract substantially undiminished after periodic payments have ended, such a promise could raise an issue. It would be unusual, if not impossible, to find such a guarantee in an annuity issued by a commercial insurer today.

If a contract permits a recovery of the investment in the contract during the course of the annuity term through, for example, a commutation right, a question that arises is by how much and how rapidly must the investment be diminished by payments in order for the contract to be considered an annuity contract. There is no definite answer to this beyond the statement in the regulations that a contract providing for the return at the end of the annuity term of an amount "substantially equal" to the consideration paid is an agreement to pay interest. This statement indicates, at a minimum, that reductions in the investment that are insignificant will be ignored and the contract may be treated as an agreement to pay interest. By the same reasoning, however, payments that do significantly diminish the investment should not be treated as payments of interest.

The Service addressed this issue of whether payments under an annuity contract represent only interest payments in a private letter ruling[13] involving a fixed immediate annuity contract. The contract provided monthly annuity payments equal to the sum of (1) guaranteed monthly payment amounts, and (2) all the interest credited to the contract's "account value" since the previous payment date in excess of the minimum guaranteed interest rate specified in the contract ("excess interest"), if any.

The contract also permitted the owner to completely surrender the contract while the annuitant was alive for an amount equal to the account value less any applicable surrender charge. In addition, the contract provided that upon the annuitant's death, the issuing company would pay to the designated beneficiary a death benefit equal to the account value, if any, on the date of death. Thus, the owner could recover his or her investment in the contract after annuity payments began in the form of monthly annuity payments, surrender proceeds, and death benefit proceeds.

The Service concluded, in part, that the contract was an annuity contract subject to Section 72, and thus it did not constitute an "agreement to pay interest" within the meaning of Section 72(j) and the regulations thereunder, because each monthly annuity payment resulted in an amortization of the investment in the contract which was at least as great as the amortization under a level payment life annuity.[14]

There is some precedent under Section 22(b)(1) of the 1939 Code, the predecessor of Section 72(j),[15] suggesting that reasonable interest rate assumptions should be referred to in determining whether the principal will in fact be recoverable in full. Specifically, at issue in the case of *Igleheart v. Commissioner*[16] were contracts that provided for annual payments and permitted the policyholder to surrender the contract at any time and recover the full principal. The Tax Court held that the purported annuity payments were actually payments of interest that did not distribute principal. This holding was based in part on the fact that the policyholder could surrender the contracts and recover the principal. However, the court stated another, independent reason for this holding:

> Furthermore,...the annual payment is based upon a presumed interest earning of either 3, or, in some instances, 3 1/2 percent of the principal sum paid for the contract. This rate is less than or not in excess of the rate each of the companies allowed on policy proceeds left on deposit during the years the contracts in controversy were executed. This fact also indicates that no part of the annual payment includes any return of capital.[17]

In affirming the Tax Court, the Court of Appeals for the Seventh Circuit also focused on the low interest rate assumed in computing the annual payments and stated that the payments "represented a percentage return less than is ordinarily earned on investments of insurance companies."[18]

Similarly, in the case of *Commissioner v. Meyer*,[19] the court held that payments under a contract were annuity payments, and not payments of interest, based in part on its conclusion that "the percentage return was far in excess of that ordinarily earned on the investments of insurance companies. From the facts there can be drawn only the inference that some part of the sums received by respondent was a return to him of his original investment."[20]

Variable Annuities: Who Owns the Underlying Assets?

Another area in which the Service has considered whether an arrangement constitutes an annuity for federal tax purposes is in the context of certain variable annuity contracts referred to as wrap-around annuities. As a general rule, the assets underlying an annuity contract are considered for tax purposes to be the property of the issuing insurance company.

. . . some banks recently have begun offering certain investment arrangements which they claim should be treated as annuities for tax purposes.

The Service, beginning in 1977, developed a limited exception to this general rule in a series of revenue rulings involving wrap-around annuities. In these rulings, income generated by assets underlying the contracts was treated as currently taxable to the policyholder because the policyholder rather than the insurance company was viewed as the "owner" of the assets, i.e., the contracts were not treated as annuity contracts for federal tax purposes.

In Revenue Ruling 77-85,[21] the Service held that the purchaser of an "investment" annuity contract, who selected and controlled one or more investments in a portfolio which comprised a life insurance company's separate account, was considered the owner of the underlying separate account assets for federal income tax purposes. Three years later, the Service held in Revenue Ruling 80-274[22] that the purchaser of an annuity contract funded solely by specified certificates of deposit issued by a savings and loan association should be treated for tax purposes as the owner of the certificates of deposits, rather than the owner of an annuity. In both situations, the policyholder, rather than the insurer that issued the annuity contract, effectively controlled the choice of the individual investments used to support the contract.

The following year, in Revenue Ruling 81-225,[23] the Service considered five situations involving investments in mutual fund shares by a separate account underlying variable deferred annuity contracts. In the four situations in which the mutual fund shares were available for purchase directly by members of the general public as well as by the insurer's separate account, the Service found the insurance company to be "little more than a conduit between the policyholders and their mutual fund shares" held in the issuing company's separate account.[24] Therefore, the Service held that the contracts were not treated as annuities and the policyholder would be considered the owner of the public mutual fund shares for federal income tax purposes, with the result that any income, gain, or loss from those shares would be includible in the policyholder's gross income.

Conversely, in the fifth situation, in which the mutual fund shares were sold only to the insurance company's separate account and were not available directly to the general public, the Service held that the insurance company, not the policyholder, should be considered the owner of the separate account assets for tax purposes. Thus, the contracts under this fifth situation were treated as annuities for federal tax purposes. The Service reiterated this position in Revenue Ruling 82-55[25] by holding, in part, that if a public mutual fund were closed to the public, then individuals who purchased annuities based on the fund's shares after it was closed would not be considered owners of those shares.[26]

Also, the Service held in Revenue Ruling 82-54[27] that individuals who purchase annuities would not be considered owners of the underlying shares of three mutual funds where the funds represented "broad general investment strategies" and were closed to the public, notwithstanding that the owners could allocate premium payments among the funds and could change such allocation at any time prior to maturity.

The continued viability and scope of Revenue Ruling 81-225 and its companion wrap-around rulings has been uncertain since the enactment by Congress in 1984 of the Section 817(h) diversification requirements. The legislative history of Section 817(h) arguably demonstrates that (1) Section 817(h)'s enactment was motivated by the same concerns with policyholder control of investments and publicly available investments that prompted the Service to issue Revenue Ruling 81-225 and its companion rulings, and (2) the diversification requirements were intended to provide a statutory solution to the issues addressed in those rulings.[28]

While the Service stated in the preamble to the temporary regulations under Section 817(h) issued in 1986 that guidance on the investor control issue would be provided in regulations or revenue rulings, no such guidance has been issued to date.[29] The Service has indicated, however, that despite the legislative history of Section 817(h), Revenue Ruling 81-225 and its companion rulings have continued vitality in at least some circumstances. In a recent private letter ruling, for example, the Service applied these rulings in holding that a number of private placement life insurance contracts issued to a single corporate policyholder, which was the sole owner of the contracts issued out of a particular separate account of the insurer, would have their underlying assets treated as owned by the insurer for tax purposes.[30]

"Annuities" Underwritten by Banks

In General. The issue of whether an arrangement constitutes an annuity for federal tax purposes has generally involved products issued by an insurance company because commercial annuities historically have been issued only by insurance companies. However, some banks recently have begun offering certain investment arrangements which they claim should be treated as annuities for tax purposes.[31]

One such arrangement is a product marketed under the name "Retirement CD™." The Retirement CD™ was developed by American Deposit Corporation and was first introduced in early 1994 by the Blackfeet National Bank (the Bank).[32]

The Retirement CD™ is available to individuals who open accounts with the Bank. Prior to the maturity date specified by the purchaser, the owner may withdraw part or all of the account balance, less a penalty.

If the owner of a Retirement CD™ has not withdrawn all of the account balance prior to the maturity date, then the owner may elect to receive a lump sum amount (the maturity cash withdrawal) equal to up to two-thirds of the account balance as of that date (the maturity balance). The maturity balance (if any), less any maturity cash withdrawal, is applied to provide monthly withdrawal payments for the owner's life, beginning approximately one month after the maturity date. Upon the death of the owner, the Bank will pay the named beneficiary any remaining account balance, without penalty.[33]

In filings with federal bank regulatory agencies, the Bank stated that it intends to treat the Retirement CD™ like any other bank deposit liability and requested (1) authority to issue the product, and (2) that the product be treated as an insured deposit. In a letter dated May 12, 1994, the Comptroller of the Currency, Administrator of National Banks (the OCC), concluded that it has no objection to the Bank marketing and offering the Retirement CD™, subject to certain conditions, because the owner's position under the Retirement CD™ is indistinguishable from the position of a bank customer under any other bank deposit arrangement (at least prior to the maturity date).[34]

Also, the Federal Deposit Insurance Corporation (the FDIC) concluded in a May 12, 1994, letter that the Retirement CD™ is entitled (subject to certain limitations) to FDIC deposit insurance protection prior to the maturity date in the same manner as any other bank deposit arrangement because it is a deposit within the meaning of the Federal Deposit Insurance Act.[35]

Is the Retirement CD™ an Annuity for Tax Purposes? The OCC and FDIC letters acknowledge the issue of whether the Retirement CD™ should be taxed as an annuity, and both agencies expressly stated that no opinion was being given regarding the tax treatment of the Retirement CD™. Is the Retirement CD™ taxable as an annuity? In the author's opinion, it is not, at least prior to the maturity date. Rather, as discussed next, the fact that the product is issued by other than an insurance company is critical to its taxation as a debt instrument, i.e., a certificate of deposit, under the original issue discount (OID) rules of the Code.

Under the OID rules set forth in Section 1272, et seq., the holder of any "debt instrument" — including a bank deposit arrangement, such as a certificate of deposit[36] — having "original issue discount" must include in gross income an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which the holder held the debt instrument.[37] The Retirement CD™ is in substance a bank deposit arrangement, at least prior to the maturity date (and is so viewed by the OCC and the FDIC). Thus, the Retirement CD™ would appear to be a debt instrument subject to the OID rules[38] unless it satisfies the exception under Section 1275(a)(1)(B) for certain private annuity contracts.

In order for the Retirement CD™ to qualify for the private annuity exception, it must (1) be an annuity contract to which Section 72 applies, and (2) "depend (in whole or in substantial part) on the life expectancy of one or more individuals."[39] Prior to its maturity date, however, the Retirement CD™ appears to fail both of these requirements.

With respect to whether the Retirement CD™ is an annuity to which Section 72 applies, it should be noted that there appears to be no precedent for recognizing any commercially available instrument as a deferred annuity for federal income tax purposes unless that instrument is issued by a company engaged in the insurance business. Moreover, there is considerable precedent, as discussed earlier in this article, for the courts and the Service to apply the fundamental principle that the substance and not the form of an arrangement governs its tax treatment to arrangements that in form claim to be deferred annuities but which in substance are not.[40]

In particular, the Service determined in Revenue Ruling 80-274, involving an annuity plan under which contracts were sold by an insurance company to depositors of participating savings and loan associations, that prior to the time the annuity payments began, the contract was treated for tax purposes as a bank deposit, and not as an annuity contract to which Section 72 applied.[41] Except for the presence in Revenue Ruling 80-274 of an intermediary insurance company, which the Service disregarded, the arrangement in that ruling appears to be indistinguishable from the Retirement CD™. Accordingly, under Revenue Ruling 80-274, prior to the maturity date the Retirement CD™ should not be viewed as an annuity contract to which Section 72 applies, but rather as a debt instrument within the meaning of Section 1275(a)(1)(A), subject to the OID rules.

Further, it seems doubtful that prior to the maturity date the Retirement CD™ satisfies the requirement under Section 1275(a)(1)(B) that it "depend (in whole or in substantial part) on the life expectancy of one or more individuals." There is considerable support for the position that Congress intended this requirement to limit the private annuity exception to immediate annuities (i.e., those annuities where payments are to begin within one year of the time that the premium is paid), and thus did not intend for that exception to apply to deferred annuities.[42] Moreover, the legislative history of the OID rules re-

. . . incremental increases in the investment earnings under an annuity contract have not been currently includible in the policyholder's gross income.

veals that Congress intended the Section 1275(a)(1)(B) private annuity exception to be narrowly construed.[43]

The only portion of the Retirement CD™ that even potentially involves the life expectancy of one or more individuals is the portion of the maturity balance that is actually applied to a lifetime payout. As mentioned above, the owner of the Retirement CD™ has the right to withdraw the entire account balance, less penalties, at any time prior to the maturity date. Hence, it is very difficult to understand how the Retirement CD™ can be said to depend either "in whole or in substantial part" on an individual's life expectancy prior to that date.

In this regard, if the Retirement CD™ were viewed as involving a real and significant possibility that life contingencies will determine the amount of the payments thereunder, and were therefore excepted out from the OID rules, it would seem that virtually any debt instrument which would otherwise be subject to the OID rules could avoid those rules. The borrower would simply have to include in its debt instruments a promise to make annuity payments using a "substantial part" of whatever amounts of principal and interest remained under the debt instrument at maturity.

Given the uncertainty as to whether the Retirement CD™ is an annuity for tax purposes, it would certainly be valuable for the Service to publish guidance. Not only do purchasers of the product need to know the Service's views, but others who might consider offering similar products also need guidance.

Current and Historical Tax Treatment of Annuities[44]

Once it has been determined whether a particular arrangement is an annuity for federal tax purposes, how is the product taxed? And how does the taxation of annuity contracts compare to the tax treatment of other savings vehicles?

Premiums and Deferral of Tax on Earnings

The premiums for a nonqualified annuity are paid in after-tax dollars, i.e., such premiums are neither excludable nor deductible from gross income for federal tax purposes. In addition, all the investment earnings under an annuity will be taxed (at ordinary income tax rates); they are never exempt. On the other hand, since the enactment of the modern income tax in 1913, the incremental increases in the investment earnings under an annuity contract — known as the inside build-up — have not been currently includible in the policyholder's gross income.[45] Rather, the inclusion in income generally is deferred until the earnings are distributed from the contract.[46]

Similarly, corporate bonds, stocks, mutual funds, and owner-occupied homes are purchased with after-tax dollars, i.e., amounts paid are neither excludable nor deductible from gross income for federal tax purposes. Also, owners of stocks, mutual funds, and owner-occupied homes can be viewed as enjoying tax treatment similar to annuity tax deferral treatment in the sense that they generally do not include in income any appreciation in value of those investments (and in the case of stocks and mutual funds, any undistributed corporate earnings) until those investments are sold.[47]

Distributions: Recovery of Investment and Taxable Earnings

In General. The income tax treatment of amounts received under an annuity contract is governed by Section 72.[48] Amounts received under an annuity contract are includible in income except to the extent that they represent a return of the "investment in the contract," i.e., premiums or other consideration paid for the contract, minus the aggregate amount previously received under the contract that was excludable from gross income.[49] Also, amounts includible in income under an annuity are taxable at ordinary income tax rates, whereas any gain on the sale or disposition of bonds, stocks, funds, and homes held for more than one year are taxable at lower capital gains tax rates.[50]

Prior to 1934, all distributions from an annuity were taxed on a "cost recovery" basis, i.e., distributions were fully excluded from gross income until the investment in the contract was recovered. All distributions received thereafter were fully includible in gross income. The Revenue Act of 1934 replaced this cost recovery approach with a statutory scheme under which distributions other than periodic annuity payments continued to be taxed on a cost recovery basis, but periodic (i.e., annual) annuity payments were taxable to the extent of 3 percent of the cost of the contract, with the balance of the annual annuity payments excluded from gross income as a return of the annuitant's investment in the contract (the 3 percent rule). All distributions became taxable in full as soon as the aggregate excluded amount equaled the investment in the contract.

The 3 percent rule was objectionable to many because of its erratic nature. For example, where the investment in the contract was small as compared to the contract's value at the time that annuity payments began, a large portion of the annual annuity payments was excluded from gross income, and thus the exclusion of investment in the contract was used up rapidly.[51]

For this reason, the Revenue Act of 1954 repealed the 3 percent rule in favor of the current exclusion ratio approach to taxing annuities contained in Section 72(b).[52] The exclusion ratio approach has been applied since 1954. Under this approach, the income tax treatment of amounts received under an annuity depends upon whether such amounts are considered "amounts received as an annuity" (e.g., annuity payments) or "amounts not received as an annuity" (e.g., partial or complete surrenders).[53]

Amounts Received as an Annuity. Payments made under an annuity contract are considered "amounts received as an annuity" for purposes of Section 72 only if they satisfy certain conditions, including the requirement that such amounts must be received after the "annuity starting date," generally the date on which annuity payments commence.[54] Annuity payments are generally treated for federal income tax purposes as having two elements: (1) an amount representing a partial recovery of the taxpayer's investment in the contract, which is excludable from gross income, and (2) the remaining amount representing earnings, which is currently includible in the taxpayer's gross income.

Section 72(b)(1) provides that the portion of each annuity payment that is excludable from gross income is determined by multiplying the amount of the annuity payment by the ratio of the investment in the contract to the "expected return" under the contract, determined in accordance with the regulations (the exclusion ratio). In the case of a variable annuity, the exclusion ratio is equal to one, and the portion of each annuity payment which is treated as an "amount received as an annuity" is determined generally as the investment in the contract (adjusted for any refund feature, discussed below) divided by the number of annuity payments anticipated under the contract.[55]

Section 72(c)(2) and the regulations thereunder provide that if an annuity contract contains a "refund feature," the investment in the contract must be adjusted in accordance with the regulations. A refund feature is defined for this purpose as including certain payments to be made to a beneficiary or the estate of an annuitant on or after the annuitant's death in the event that a specified amount or stated number of payments has not been paid prior to death.[56] This refund feature adjustment reduces the investment in the contract, and thus the exclusion ratio, with the result that a lower portion of each annuity payment is treated as a recovery of principal and excluded from income.

This adjustment was intended to prevent a double exclusion from income of an amount in the nature of a refund under both the exclusion ratio and the provisions of Section 72(e)(5)(E) relating to certain "amounts not received as an annuity."[57] This adjustment sometimes causes a glitch in the operation of Section 72 which delays, and potentially denies, full recovery of the investment in the contract for an annuity with a refund feature. However, legislation currently pending in Congress would remedy the deficiency.[58]

As originally enacted in the Revenue Act of 1954, the exclusion ratio applied to all annuity payments, without limitation. If, for example, an individual receiving lifetime annuity payments outlived his or her life expectancy, the aggregate amount excludable from gross income under the exclusion ratio would exceed the investment in the contract. Also, if the individual died before recovering the entire investment in the contract, no deduction was permitted for the unrecovered portion. In 1986, Congress amended Section 72(b) as part of the 1986 Act to limit the aggregate amount excludable from gross income under the exclusion ratio to the investment in the contract and to permit a deduction under Section 72(b)(3)(A) for any unrecovered investment in the contract.

Amounts Not Received as an Annuity. As noted above, if payments made under an annuity contract do not qualify as "amounts received as an annuity," they are classified as "amounts not received as an annuity" for purposes of Section 72. Such amounts include amounts received on the complete or partial surrender of a contract, periodic payments in excess of the amounts provided for on the annuity starting date which are in the nature of dividends (increased payments), and certain amounts received on the death of an annuitant.[59] The tax treatment of amounts not received as an annuity depends upon whether such amounts are received before or after the annuity starting date.

Prior to 1982, amounts not received as an annuity before the annuity starting date were taxed on a cost recovery basis.[60] Since 1982, such amounts (i.e., amounts received in a partial withdrawal or partial surrender) are taxable as ordinary income to the extent that the cash value of the contract exceeds the investment in the contract.[61] Congress enacted this income-out-first rule under Section 72(e) as part of the Tax Equity and Fiscal Responsibility Act of 1982 (the 1982 Act)[62] in order to discourage the use of deferred annuity contracts as short-term investments and to encourage their use for long-term investment and retirement goals.

Amounts not received as an annuity on or after the annuity starting date (e.g., increased payments) are fully includible in gross income.[63] However, amounts received upon a complete surrender or the annuitant's death (i.e., amounts in the nature of a refund), are included in gross income only to the extent that they, when added to amounts previously received under the contract which were excludable from gross income, exceed the consideration paid for the contract.[64]

Loans and Gifts Trigger Tax

Pursuant to Section 72(e)(4)(A), enacted as part of the 1982 Act, the amount of any loan taken from an annuity contract, and the pledge or as-

... current tax rules are designed to limit tax deferral treatment to annuities used for retirement purposes ...

signment of an annuity contract, are treated as distributions, i.e., an amount not received as an annuity. Thus, the amount loaned, pledged or assigned is taxable on an income-out-first basis.[65] Also, under Section 72(e)(4)(C), enacted as part of the 1986 Act, any gift or other gratuitous transfer of an annuity is treated as a distribution of the entire cash value of the annuity with the result that all income accumulated under the annuity is taxed at that time to the owner.[66]

In contrast, bonds, stocks, mutual funds, and homes can be used as security for a loan without giving rise to income (or penalties, discussed next). Also, interest on a loan secured by a home generally is deductible.[67] Moreover, unlike the gratuitous transfer of an annuity, the gift of bonds, stock, mutual funds, and a home generally do not give rise to income tax, and the donee receives a carryover basis in the property transferred.[68] Thus, the tax treatment of annuities is less advantageous than that for these other vehicles in these respects.

Penalty Tax on Premature Distributions

To encourage the use of annuities for retirement needs, Congress enacted, as part of the 1982 Act, the so-called penalty tax under Section 72(q)(1). The penalty tax applies to premature distributions under an annuity contract, whether or not received as an annuity, unless the distribution falls within one of the exceptions set forth in Section 72(q)(2).

As originally enacted, this additional tax was equal to 5 percent of the amount includible in income under the rules outlined above, and only applied to the extent that the amount was allocable to an investment made within 10 years of the receipt of such amount. As part of the Deficit Reduction Act of 1984 (the 1984 Act),[69] consistent with a general objective of encouraging the use of annuities for retirement savings as opposed to short-term savings, Congress eliminated the 10-year aging exception to the penalty tax, with the result that the penalty tax was broadened to apply (with certain limited exceptions) to any withdrawal prior to age 59 1/2.[70] Also, the 1986 Act increased the penalty tax from 5 percent to its current rate of 10 percent.

No Deferral Beyond Owner's Death

The current tax rules are designed to limit tax deferral treatment to annuities used for retirement purposes and to prevent their use to achieve deferral beyond that time. Under Section 72(s), enacted as part of the 1984 Act, an annuity contract, by its terms, must require that the "holder's" entire interest in the contract be distributed when the holder dies. The Section 72(s) "distribution at death" rules are intended to assure that the savings accumulated during the owner's lifetime will be distributed promptly after death if they have not been distributed during his or her life (except in the case of a contract's continuation for the benefit of a surviving spouse, where continued deferral is specifically permitted).[71]

Section 72(s) requires generally that if annuity payments have not begun (i.e., the holder dies before the annuity starting date), the contract value must be entirely distributed within five years or must begin to be distributed within one year of death as a life or life expectancy annuity. (Again, continued deferral is permitted in the case of a surviving spouse.) If annuity payments have already begun (i.e., the holder dies after the annuity starting date), the payments must continue to be paid out at least as rapidly as they were being paid prior to death.

The Section 72(s) distribution at death requirements were revised by the 1986 Act in several respects. First, that Act added Sections 72(s)(6) and (7), providing that if the holder of an annuity contract is not an individual, (1) the "primary annuitant" is treated as the holder, and thus the death of the annuitant triggers the distribution requirements, and (2) a change of the primary annuitant will trigger the distribution requirements.[72] In addition, the 1986 Act amended Section 72(s)(1) to provide that if there is more than one holder, required distributions are triggered upon the death of any holder.

Unlike with annuities (the earnings under which are never exempt from tax), if the owner of stocks, mutual funds, and a home holds such property until death, the basis in the property will be stepped-up, with the result that any prior untaxed appreciation in value will escape federal income tax.[73]

Investment Diversification, Non-natural Owners, and the Aggregation Rule

In addition to the legislative actions discussed above, Congress has made several other fine tuning adjustments to the tax treatment of nonqualified annuities to encourage their use for long-term retirement savings. For instance, Congress enacted, as part of the 1984 Act, the Section 817(h) diversification requirements. As mentioned above, the diversification requirements provide that for purposes of subchapter L (relating to the income tax treatment of life insurance companies), Section 72 (relating to the treatment of distributions from annuities, endowments and life insurance contracts), and Section 7702(a) (defining a life insurance contract), a variable contract will not be treated as an annuity, endowment, or life insurance contract for any period for which the investments made by the separate account on which the contract is based are not adequately diversified in accordance with regulations.

Congress enacted the diversification requirements to discourage the use of variable annuities (and variable life insurance contracts) primarily as investment vehicles. Congress believed that limiting a contract holder's ability to select specific investments underlying a variable contract would help ensure that the contract holder's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance.[74]

Also, the 1986 Act added Section 72(u), providing generally that a nonqualified deferred annuity contract will not be treated as an annuity contract for federal income tax purposes (other than subchapter L of the Code), and thus the inside build-up will be taxed currently, if the contract owner is not an individual. For instance, a corporate owner must pay current tax on the annual increases in value of a nonqualified annuity. Section 72(u)(1) states that the holding of an annuity by a trust or other entity "as an agent for a natural person" shall not be taken into account for this purpose.

Finally, the 1988 Act added the Section 72(e)(11) aggregation rule, under which all deferred annuity contracts issued by the same insurance company to the same policyholder during any calendar year are treated as one annuity contract. This aggregation rule prevents the marketing of multiple deferred annuities, referred to as serial contracts, designed to avoid the income-out-first rules of Section 72(e).[75]

Proposals to Limit or Eliminate Tax Deferral Treatment

Proposals to Restrict or Eliminate Tax Deferral Treatment for Annuities Have Been Rejected

As mentioned above, annuities are recognized as an important means for individuals to accumulate savings. The history of the tax treatment for annuities discussed above reflects that Congress, courts, and the Service have safeguarded annuity tax treatment while denying its application to situations perceived as abusive. In the past, Congress has wisely rejected proposals to restrict annuity tax treatment beyond that which it viewed as necessary to focus use of annuities for their intended uses.

In 1978 and 1984, the Treasury Department proposed the repeal of the tax deferral treatment afforded the inside build-up of annuities. Also, at the direction of Congress, the Treasury Department and the General Accounting Office (GAO) issued in 1990 separate reports addressing the tax treatment of annuity and life insurance contracts,[76] and questioning in some respects the treatment of inside build-up. The GAO report concluded that Congress might want to periodically reconsider its policy decision to grant tax deferral treatment to inside build-up, weighing the social benefits of such treatment against the tax revenue forgone.[77]

The Treasury report stopped short of suggesting outright repeal of the tax deferral treatment for annuities, but did suggest that such treatment should continue only with respect to an annuity with a "significant life contingency."[78] The impact of this suggested change, however, would be essentially the same as repealing tax deferral treatment, since the significant life contingency requirement proposed would have made annuities unattractive and effectively unmarketable.

More recently, in 1992, President Bush's budget message included a proposal, similar to that in the 1990 Treasury report, to allow tax deferral on the inside build-up of deferred annuities only for annuities with "substantial life contingencies." Under the proposal:

> [f]or ... annuities [without substantial life contingencies], investment income would be taxed as earned. The distinction between annuities would be based on whether the annuity contains a substantial risk of loss of investment if the taxpayer dies prematurely. The policy would generally be considered an annuity for tax purposes only if payments were guaranteed (1) for a period of time equal to less than one-third of the annuitant's remaining life expectancy on the annuity starting date, or (2) for less than one-third of the annuity's cash value on the annuity starting date (or date of death, if earlier).[79]

All of these proposals were rejected. Such proposals were based generally on concerns that the existing tax rules do not adequately limit annuities to their intended uses. It was in response to such concerns that Congress enacted legislation throughout the 1980s to tighten the tax rules governing annuity (and life insurance) contracts. As discussed above, Congress, after careful and thorough review and with Treasury support, made significant changes to the tax treatment of annuities as part of the 1982, 1984, 1986, and 1988 Acts in order to ensure that such contracts are not utilized as short-term investment vehicles. Hence, the fundamental objection raised in connection with proposals to tax the inside build-up — that annuities can be used to shelter income from short-term investments — has already been successfully addressed by Congress.

Congressional Fine Tuning of Annuity Tax Treatment Has Been Effective

As explained above, in order to encourage the use of deferred annuity contracts for long-term investment and retirement goals, Congress enacted in 1982 the Section 72(q)(1)

. . . individuals purchase annuities to provide protection against outliving their assets during their retirement years.

penalty tax on premature distributions (later refined under the 1984 and 1986 Acts), the Section 72(e) income-out-first rule, and the rule under Section 72(e)(4)(A) taxing loans as distributions. In addition, Congress added Section 72(e)(4) in 1986 to tax gratuitous transfers of annuities as distributions and added the Section 72(e)(11) aggregation rule in 1988 to prevent multiple deferred annuities designed to avoid the income-out-first rule.

Moreover, Congress enacted the Section 72(s) distribution at death rules in 1984 (and amended them in 1986) to assure generally that the savings accumulated during the owner's lifetime will be distributed promptly after death, if they have not been distributed during his or her life. Also in 1984, the Section 817(h) diversification requirements were enacted to frustrate the nondiversified use of publicly available mutual funds as funding vehicles for nonqualified variable annuity contracts. In 1986, Congress added Section 72(u) to limit annuity tax treatment generally to annuity contracts owned by individuals.

The available evidence demonstrates that these changes to the tax treatment of annuities have had their intended result. The Gallup Organization surveyed owners of nonqualified annuities in 1992, 1993, and 1994 on behalf of the Committee of Annuity Insurers.[80] These surveys show that over 80 percent of the owners of nonqualified annuities have annual household incomes of less than $75,000 and that 16 percent have incomes of less than $20,000. The surveys also show that the average nonqualified annuity owner is age 64. This result suggests that nonqualified annuities typically are owned by low and middle income individuals who are nearing or entering retirement.

Furthermore, the Gallup surveys support the conclusion that annuities are purchased for the purpose of providing savings for financial needs during retirement. In particular, the surveys show that in addition to using annuity savings for retirement and/or living expenses, over 70 percent of individuals purchase annuities because they wish to use annuity savings as an emergency fund in the event of a catastrophic illness or the need for nursing home care. Stated differently, individuals purchase annuities to provide protection against outliving their assets during their retirement years.

The Gallup surveys demonstrate that the current tax treatment of annuities is sufficiently restrictive to effectively encourage their intended uses and, at the same time, prevent tax abuse. Nevertheless, in light of the budget deficit, some have viewed restricting, and even eliminating, the current tax deferral treatment of annuities as a source of tax revenues. In 1993, for example, the Clinton administration apparently considered ways to limit the benefits from tax deferral of inside build-up in order to raise revenues to pay for the General Agreement on Tariffs and Trade and/or welfare reform.[81]

However, as the Treasury and GAO reports indicate, restricting or eliminating the tax deferral treatment of annuities would have unintended adverse consequences. In this regard, if tax deferral treatment — a fundamental feature of annuities that encourages savings — were further restricted or repealed, obviously annuities would be purchased less frequently as savings vehicles.[82] The Treasury and GAO reports suggest that if annuities and other savings vehicles are underutilized, any resulting gap in family protection inevitably would fall most heavily on low income families and elderly Americans and likely would have to be filled with costly and cumbersome government assistance programs.[83] The reports implicitly recognize that in rejecting all previous proposals to tax the inside build-up of annuities, Congress recognized that the increased revenue generated from taxing inside build-up would be outweighed by the costs to society of reduced individual savings, including the possibility of direct government provision of income assistance.[84]

It is interesting to note that the Treasury report seems to suggest that further restricting the tax deferral treatment of annuities might well have an effect similar (though less dramatic) to repealing tax deferral. This suggestion follows the report's observations that the tax treatment of life insurance and annuity products had been reviewed and changed several times throughout the 1980s, and that such continual changes and reviews might create uncertainty about the future rules, thereby discouraging the purchase of such products.[85] Query whether the repeated attacks on the treatment of life insurance products and annuities in recent years, and the recommendation in the GAO report that Congress periodically reconsider whether to repeal tax deferral treatment, already has had such an effect.

In short, proposals to restrict, or even eliminate, the tax deferral treatment of annuities are contrary to sound policy. This is especially true in light of the fact that it is becoming increasingly more difficult for individuals to save for retirement. Specifically, increases in life expectancies and trends toward earlier retirement increase the number of years individuals can expect to spend in retirement, and thus increase their need for retirement savings.[86]

Changing demographics reveal that the percentage of the U.S. population in retirement will increase significantly in the future. The youngest members of the baby boom generation — approximately 76 million people born between 1946 and 1964[87] — turned 30 years old in 1994. As the baby boom generation ages, the percentage of the U.S. population that is considered to be elderly will increase, as will the percentage of the population that is retired. The percentage of the population age 65 is projected to increase from 11 percent today to 16.7 percent in the year 2020.[88]

Given these demographics and social trends, it is not difficult to understand that there are limits on what Social Security can realistically provide. There are currently 3.2 workers paying Social Security taxes for every retiree drawing Social Security benefits, compared to 8.6 workers for each beneficiary in 1955. This ratio will drop to 2.2-to-1 in 2025, when today's 35-year-olds are contemplating retirement.[89] This has led some to predict that Social Security will run out of money in the year 2029.[90] Indeed, a recent survey revealed that more individuals between the ages of 18 and 34 believe in UFOs than believe that the Social Security system will provide them with any retirement benefits.[91]

The budgetary constraints threatening Social Security likely will adversely affect the amount of benefits that are paid. Congress has already slightly pushed back the retirement age for Social Security. Also, consideration has been given to such benefit-reducing measures as (1) further increasing the retirement age at which an individual can retire with full Social Security benefits, (2) reducing the amount of such benefits, (3) reducing spousal benefits, and (4) reducing the cost-of-living adjustment to benefits.[92]

Hence, as the baby boom generation ages and a larger percentage of the population enters retirement, it becomes increasingly important that Social Security benefits be augmented with supplemental sources of retirement income, i.e., private pension plans and private savings, if a typical retiree's minimum survival needs are to be met. Currently, however, the availability of private pensions is limited.

Continual legislative and regulatory initiatives — including decreasing or eliminating deductible contributions to defined benefit pension plans, Section 401(k) plans, and individual retirement accounts and annuities, and imposing penalty taxes on retirement benefits above a specified level — have raised the burden of establishing and maintaining qualified pension plans, causing employers to question the desirability of maintaining such plans.[93]

As a consequence of these tax law changes to pension plans, fewer and fewer employees are covered by traditional pension plans that promise a specific level of income on retirement (so-called defined benefit plans). Rather, more employers are offering their employees so-called defined contribution plans and Section 401(k) plans, under which there is no certainty of a stable, monthly income lasting from retirement until death.

Thus, American workers are being forced to assume an increasing level of responsibility for their own retirement. However, the personal saving rate in this country is lower than that in all major industrialized countries[94] and has steadily decreased over recent years. In 1970, 8 percent of disposable personal income went toward savings.[95] By 1991, this number was down to 4.7 percent.[96] For the year ending in August 1994, personal saving as a share of after-tax income fell to 3.8 percent, the lowest level recorded for any 12-month period.[97]

In short, it is widely recognized that planning for retirement is likely to be increasingly an individual responsibility. Accordingly, it would not be sound policy to restrict (or eliminate) the tax deferral treatment of annuities. Stated differently, Congress must resist the temptation of making annuity tax treatment a victim in the tug of war over the budget deficit. The Code reflects the importance of annuity tax treatment, effectively encourages savings through annuities, and, at the same time, is capable of preventing the potential abuses that would result from extending annuity tax treatment to arrangements other than those Congress intended.

Conclusion

The current federal income tax treatment of annuities reflects the policy view that annuities are an important and effective means for low and middle income families to accumulate personal savings to provide basic and supplemental retirement income. As a result of the legislative fine-tuning of the tax treatment of annuities over the years, that treatment is sufficiently restrictive to encourage long-term saving for retirement and, at the same time, prevent tax abuse. In this author's view, any legislative action to further restrict or to repeal the current tax treatment of annuities would be inappropriate and contrary to sound federal policy, particularly in light of the fact that Americans are being forced to assume an increasing level of responsibility for their own retirement. **J**

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Mark E. Griffin, Esq., is counsel to Davis & Harman, Washington, D.C. He received his BA from Hamilton College, his J.D. from Syracuse University College of Law, and his LL.M. in Taxation from Georgetown University Law Center.

(1) The author wishes to thank Joseph F. McKeever, III, a partner with Davis & Harman, Washington, D.C., for his substantial contribution in connection with this article.

(2) *See, e.g., Samuel v. Commissioner*, 306 F.2d 682, 686 (1st Cir. 1962); *Silberman v. United States*, 333 F. Supp. 1120, 1125 (W.D. Pa. 1971); Rev. Rul. 66-322, 1966-2 C.B. 123; Rev. Rul. 57-191, 1957-1 C.B. 162. For an excellent discussion of the classification and types of annuities, see K. Black, Jr. & H. Skipper, Jr., *Life Insurance* 147-176 (12th ed. 1994).

(3) *See, e.g., NationsBank of North Carolina, N.A., et al. v. Variable Annuity Life Insurance Company et al.*, 115 S. Ct. 810 (1995) (the VALIC case) (considering annuities under federal banking law); *Securities and Exchange Commission v. Variable Annuity Life Insurance Co.*

of America et al., 79 S. Ct. 618 (1959) (considering annuities under federal securities law).
(4) Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (i.e., the Code).
(5) H.R. Rep. No. 1337, 83d Cong., 2d Sess. 11 (1954) (the 1954 Act House Report); S. Rep. No. 1622, 83d Cong., 2d Sess. 12 (1954) (the 1954 Act Senate Report).
(6) Treas. Reg. § 1.72-2(a)(1).
(7) *See* Rev. Rul. 77-286, 1977-2 C.B. 278; Priv. Ltr. Ruls. 8715038, 8624001, 8442007, and 8335035; Gen. Couns. Mems. 39720 and 38378; Tech. Adv. Mem. 8702002.
(8) *See, e.g.*, Davis W. Gregg & Vane B. Lucas, *Life and Health Insurance Handbook* 85 (3d ed. 1973).
(9) *See Northern Trust Co. v. United States*, 389 F.2d 731, 733 (7th Cir. 1968); Gen. Couns. Mem. 38934.
(10) See Priv. Ltr. Rul. 8413034.
(11) *See, e.g., Igleheart v. Commissioner*, 174 F.2d 605 (7th Cir. 1949), *aff'g* 10 T.C. 766 (1948); *Commissioner v. Meyer*, 139 F.2d 256 (6th Cir. 1943); Rev. Rul. 75-225, 1975-2 C.B. 22.
(12) Treas. Reg. § 1.72-14(a).
(13) It should be noted that private letter rulings are not actually precedent and may be relied on only by the taxpayer to whom they are issued. See IRC § 6110(j)(3). However, they are widely accepted as indicating the Service's views on the issues presented therein.
(14) *See* Priv. Ltr. Rul. 9237030.
(15) IRC § 72(j) was enacted as part of the Internal Revenue Code of 1954 and has never been amended. The legislative history of the 1954 Code states that "[t]his [subsection] corresponds to Section 22(b)(1) of the 1939 Code. No substantive change is made." 1954 Act Senate Report at 177.
(16) *See supra* note 11.
(17) 10 T.C. at 770.
(18) 174 F.2d at 607.
(19) *See supra* note 11.
(20) 139 F.2d at 259. *Cf. Edgar v. Commissioner*, 56 T.C. 717, 742-43 (1971) (in determining whether payments diminished principal, it is improper to use the 4 percent rate assumed in annuity tables; rather, the actual return should be referred to).
(21) 1977-1 C.B. 12.
(22) 1980-2 C.B. 27.
(23) 1981-2 C.B. 13.
(24) 1981-2 C.B. at 14.
(25) 1982-1 C.B. 12.
(26) *See also Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir. 1984), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984) (using an analysis similar to that set forth in Rev. Rul. 81-225).
(27) 1982-1 C.B. 11.
(28) *See* S. Rep. No. 169, 98th Cong., 2d Sess., Vol. I, 546 (1984) (the 1984 Act Senate Report); H.R. Rep. No. 861, 98th Cong., 2d Sess. 1055 (1984) (the 1984 Act Conference Report); Jt. Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 607-08 (Jt. Comm. Print 1984) (the 1984 Act Blue Book).
(29) *See* T.D. 8101, 1986-2 C.B. 97, 98. Final regulations under Section 817(h) were issued in 1989. *See* T.D. 8242, 1989-1 C.B. 215.
(30) *See* Priv. Ltr. Rul. 9433030.
(31) The Supreme Court in the *VALIC* case (*see supra* note 3), considering the status and nature of annuities under the National Bank Act, recently upheld a determination by the Comptroller of the Currency, Administrator of National Banks, that national banks may serve as agents in the sale of insurer issued annuities. In so holding, the Court determined that annuities are not "insurance" for purposes of a provision of that act that effectively prohibits banks from acting as agents by "soliciting and selling insurance" if they are located in towns of more than 5,000 inhabitants. The Court emphasized that the question of whether annuities are insurance depends on the context in which the question is asked, and stressed that it was addressing the status of annuities only in the context of federal banking law. Specifically, the *VALIC* case does not consider the status of annuities for federal tax purposes. Moreover, *VALIC* involved bank sales of insurer issued annuity contracts, and thus does not address questions concerning the treatment of a bank issued arrangement as an annuity.
(32) At the time this article was written, at least three banking institutions have been licensed to offer the product for sale. *See* Amy S. Friedman, *Banking Regulators May Issue Retirement CD™ Sales Guidelines*, National Underwriter, Life & Health/Financial Services 23 (Feb. 13, 1995). The promoters of the Retirement CD™ have been quoted as stating that they want all banks to be able to offer it. *See* N.Y. Times, Feb. 14, 1994, at D1.
(33) The description of the Retirement CD™ set forth in this article is based on (1) a sample contract and marketing materials furnished to the Federal Deposit Insurance Corporation by the Bank and its agents; (2) a letter from the Comptroller of the Currency, Administrator of National Banks, to the President and Chief Executive Officer of Bank dated May 12, 1994; and (3) a letter from the Federal Deposit Insurance Corporation to the American Deposit Corporation dated May 12, 1994.
(34) *See* letter from the OCC to the President and Chief Executive Officer of the Bank (May 12, 1994).
(35) *See* letter from the FDIC to the American Deposit Corporation (May 12, 1994).
(36) *See* Treas. Reg. § 1.1275-1(d); Priv. Ltr. Rul. 9041056.
(37) See IRC § 1272(a)(1).
(38) The term "original issue discount" is defined in IRC § 1273(a)(1) as the excess, if any, of the stated redemption price at maturity over the issue price. The Retirement CD™ would appear to have original issue discount within the meaning of that section because its stated redemption price at maturity (i.e., its account balance, including interest credited throughout its term) will exceed its issue price (i.e., the deposits made by the owner). See IRC § 1273(a)(2) and (b); Treas. Reg. § 1.1273-1(b) and 2(a)(1).
(39) *See* IRC § 1275(a)(1)(B).
(40) *See* Rev. Rul. 81-225, *supra* note 23; Rev. Rul. 80-274, *supra* note 22; Rev. Rul. 77-85, *supra* note 21.
(41) *See* 1980-2 C.B. at 28-29. *See also* Priv. Ltr. Rul. 8146066 (applying Rev. Rul. 80-274 to a similar factual situation involving a purported annuity contract offered by an insurance company to depositors of various savings institutions).
(42) Congress used the same requirement in defining a private annuity under IRC § 1275(a)(1)(B) that it had used in two different places in the Code — in IRC § 72 and in former IRC § 483(f) (which was incorporated into the OID rules). *See* 1984 Act Blue Book at 114. Each time the requirement was interpreted as applying only to annuities in the payout stage. *See* IRC § 72(c)(2) and (3); former IRC § 483; Treas. Reg. § 1.483-2(b)(5).
(43) See 1984 Act Conference Report at 887; 1984 Act Blue Book at 120.
(44) For a good, detailed discussion of the tax treatment of annuities, see American Bar Association Section of Taxation, Committee on Insurance Companies, A Roadmap to the federal Income Taxation of Non-Qualified Annuity Contracts, 45 *Tax Lawyer* 123 (Fall 1991).
(45) The inside build-up of annuity (and life insurance contracts) historically has not been subject to current taxation to the owner on the theory that the policyholder is not in constructive receipt of the periodic increments in the contract's investment earnings, and thus realized no income. *See, e.g., Cohen v. Commissioner*, 39 T.C. 1055, 1063 (1963) (life insurance policy).
(46) *See* IRC §§ 72 and 451; Treas. Reg. § 1.451-2. As discussed in the following text, since the Tax Reform Act of 1986, Pub. L. No. 99-514 (the 1986 Act), earnings under corporate-owned annuities have been subject to current tax (i.e., the inside

build-up for annuities other than those owned by individuals is taxed currently). *See* IRC § 72(u).
(47) *See* IRC § 1001.
(48) The annuity provisions, as enacted as part of the Revenue Act of 1913, were originally set forth in Section 22 of the 1939 Code and were redesignated under IRC § 72 as part of the Revenue Act of 1954.
(49) *See* IRC § 72(c)(1).
(50) *See* IRC §§ 1(h), 302, and 1222(3).
(51) *See* 1954 Act House Report at 10; 1954 Act Senate Report at 11.
(52) *Id.*
(53) *See* IRC § 72(b) and (e); Treas. Reg. § 1.72-1(b), (c)(1), and (d).
(54) *See* IRC § 72(c)(4); Treas. Reg. § 1.71-2(b)(2) and 4(b)(1).
(55) *See* Treas. Reg. § 1.72-2(b)(3), 5(f), and 6.
(56) *See* IRC § 72(b) and (c); Treas. Reg. § 1.72-7.
(57) *See* 1954 Act House Report at 10; 1954 Act Senate Report at 11.
(58) *See* Section 4(m) of H.R. 1121, 104th Cong., 1st Sess. (1995).
(59) *See* Treas. Reg. §§ 1.72-4(a)(3), 1.72-11(a)(1).
(60) *See* S. Rep. No. 494, 97th Cong., 2d Sess. 349-51 (1982); H.R. Rep. No. 530, 97th Cong., 2d Sess. 647 (1982); Jt. Comm. on Taxation, 97th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* 361 (Jt. Comm. Print 1982).
(61) *See* IRC § 72(e)(1), (2), and (3).
(62) Pub. L. No. 97-248.
(63) *See* IRC § 72(e)(1)(B) and (2)(A); Treas. Reg. § 1.72-11(b)(2) and (d).
(64) *See* IRC § 72(e)(5)(A) and (E); Treas. Reg. § 1.72-11(c)(1) and (d). Different rules will apply where the total amount to be paid in discharge of the obligation to make payments under the contract can exceed the total annuity payments which would otherwise discharge the obligation. *See* Treas. Reg. § 1.72-11(c) and (e).
(65) Prior to 1988, the investment in an annuity contract was not increased by loans that were taxable under IRC § 72(e)(4)(A), as added by the 1982 Act. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (the 1988 Act), amended IRC § 72(e)(4)(A) to provide for an increase in basis for taxable loans.
(66) *See* IRC § 72(e)(4). There is an exception for transfers between spouses or incident to divorce.
(67) *See* IRC § 163(h)(3).
(68) *See* IRC § 1015.
(69) Pub. L. No. 98-369.
(70) *See* H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1450-51 (1984) (the 1984 Act House Report); 1984 Act Senate Report at 580; 1984 Act Conference Report at 1077; 1984 Act Blue Book at 658.
(71) *See* 1984 Act House Report at 1451; 1984 Act Senate Report at 580-81; 1984 Act Conference Report at 1077-78; 1984 Act Blue Book at 659.
(72) In this connection, Section 72(u) sets forth certain provisions relating to whether an annuity contract constitutes an annuity for income tax purposes where it is not held by an individual.
(73) *See* IRC § 1014.
(74) *See* 1984 Act Senate Report at 546; 1984 Conference Report at 1055; 1984 Blue Book at 607.
(75) *See* H.R. Rep. No. 1104, 100th Cong., 2d Sess., Vol. II, 103 (1988). It should be noted that the aggregation rule of IRC § 72(e)(11) does not apply to immediate annuities, and thus does not apply to so-called split-annuity arrangements involving the contemporaneous purchase of an immediate annuity and deferred annuity. However, in some circumstances, the Service might treat a split-annuity arrangement as a single contract under its general authority to prescribe rules and regulations. *See* H.R. Rep. No. 386, 101st Cong., 1st Sess. 665 (1989).
(76) *See* United States General Accounting Office, *Tax Treatment of Life Insurance and Annuity Accrued Interest* (Jan. 1990) (GAO/GGD-90-31) (the GAO report); Department of the Treasury, *Report to The Congress on the Taxation of Life Insurance Company Products* (March 1990) (the Treasury report). Section 5014 of the 1988 Act had directed the Treasury Department and the Comptroller General of the United States to conduct separate studies, in part, on the policy justification for, and the practical implications of, the tax deferral treatment of insurance products.
(77) *See* GAO report at 3, 46.
(78) *See* Treasury report at 3.
(79) Department of the Treasury, *General Explanations of the President's Budget Proposals Affecting Receipts* 99 (Jan. 1992). In the 1995 version of its annual report, the Congressional Budget Office included a modified version of the proposal contained in President Bush's 1992 budget message. *See* Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (Mar. 3, 1995).
(80) The Committee of Annuity Insurers is a coalition of 47 life insurance companies whose members include most of the principal annuity insurers in the United States. The Committee was formed in 1981 to address the federal legislative and regulatory issues confronting the annuity industry and to participate in the development of federal policy regarding annuity taxation.
(81) *A New Strategy for Welfare Reform*, N.Y. Times, April 21, 1994.
(82) *See* Treasury report at 39, 42, 45; GAO report at 39, 44.
(83) *See* Treasury report at 40, 42, 45; GAO report at 4, 44.
(84) *Id.*
(85) *See* Treasury report at 45.
(86) *See* Jt. Comm. on Taxation, 102d Cong., 1st Sess., *Description and Analysis of S.612 (Savings and Investment Incentive Act of 1991)* 67 (1991) (the Joint Committee report).
(87) *See* The Congress of the U.S. Congressional Budget Office, Baby Boomers in Retirement: An Early Perspective 2 (1993).
(88) *See, e.g.*, U.S. Senate Special Committee on Aging, American Association of Retired Persons, Federal Council on the Aging, and U.S. Administration on Aging, *Aging America, Trends and Projections* 1-35 (1991).
(89) *See* Neal St. Anthony, *Boomers or Bust?*, Star Trib. 1D (Jul. 24, 1994); *ASPA Proposes "Drastic" Measures to Head Off Crisis in Retiree Income*, 21 Pens. Rep. (BNA) No. 30, 1459 (Jul. 25, 1994).
(90) *Poll Finds Young Americans Doubt Social Security Future*, Washington Post, Sep. 27, 1994, at B1 ("Right now, the Social Security trust funds take in more money than they spend. ... But during the retirement years of the baby boomers, ... annual benefits will exceed receipts and the trust funds will be exhausted by 2029, unless changes are made."). On April 11, 1994, the Clinton Administration reported that the Social Security trust fund for the disability program would be exhausted by 1995, and the trust fund for the retirement program would be exhausted by 2036. Just last year, the Administration predicted that the trust fund for the retirement program would last until 2044.
(91) *Id.*
(92) *See Four in House Outline Social Security Cuts*, Washington Post, Sep. 28, 1994, at A17.
(93) *The Pension Legacy: The Case For Preserving The Private Pension System*, American Council of Life Insurance, at 6.
(94) For example, as of 1982, Americans saved 6.2 percent of disposable personal income, compared to 15.2 percent in Canada, 14.2 percent in Germany, and 17.7 percent in Japan. *See, e.g.*, Joint Committee report, *supra* note 86 at 51.
(95) *See* U.S. Dep't of Commerce Statistical Abstract of the United States 1993 448 (113th ed. 1993).
(96) *Id.* This actually represents an increase from 1989, when the saving rate was only 4.0 percent of personal disposable income.
(97) *Americans Run Out of Options to Boost Their Spending*, Washington Post, Oct. 30, 1994, at B10, B13.

Communications

Update on The Federal Taxation of Annuities: A Success Story

To the Editor:

The purpose of this letter is to provide a brief update to my article, The Federal Taxation of Annuities: A Success Story published in the May 1995 issue of this Journal. In my article, I mentioned that some banks recently have begun offering arrangements which they claim should be treated as deferred annuities for Federal income tax purposes. As mentioned in the article, if a contract is both a "debt instrument" and an annuity contract issued by other than an insurance company, it is subject to taxation as a debt instrument under the original issue discount ("OID") provisions of the Internal Revenue Code (the "Code"), rather than as an annuity contract under section 72 of the Code, unless it qualifies for the annuity exception to the OID provisions set forth in Code section 1275(a)(1)(B)(i).

In this connection, the article considered one such bank arrangement marketed under the name Retirement CD and stated generally that, in my opinion, a bank-issued "annuity" like the Retirement CD does not qualify for the section 1275(a)(1)(B)(i) annuity exception, and thus is not an annuity for tax purposes, at least prior to its maturity. I concluded that, at least during the deferral stage prior to maturity, such a bank-issued arrangement should be taxable as a debt instrument under the OID provisions. At the time the article went to press, there was no clear guidance on this issue, and I indicated that it would be valuable for the Internal Revenue Service to publish such guidance.

On April 7, 1995, the Internal Revenue Service issued proposed regulations stating that an annuity contract issued by other than an insurance company will satisfy the section 1275(a)(1)(B)(i) annuity exception, and thus will not be treated as a debt instrument under the OID rules:

only if all payments under the contract are periodic payments that —

(A) are made at least annually for the life (or lives) of one or more individuals:

(B) do not increase at any time during the term of the contract: and

(C) are part of a series of payments that begins within one year of the date of the initial investment in the contract. Prop. Treas. Reg. section 1.1275-1(d)(2)(i).

The requirement that all payments under the contract be periodic payments operates to prevent a contract with a commutation right or surrender right from qualifying for this exception.

The requirement that payments must begin within one year of the initial investment precludes a deferred annuity issued by other than an insurance company from satisfying the proposed regulations. In this connection, the rule that payments cannot increase at any time during the term of the contract prevents a contract that is in substance a deferred annuity from avoiding the proposed regulations by providing a pattern of very smallpayments beginning within one year from the initial investment, followed by a series of much higher payments beginning more than one year from that investment.

In addition, the proposed regulations provide that an annuity issued by a noninsurer does not fail to qualify for the section 1275(a)(1)(B)(i) annuity exception merely because it provides for a payment (or payments) made by reason of the death of one or more individuals. See Prop. Treas. Reg. 1.1275-1(d)(2)(ii). While it is not entirely clear from the face of the proposed regulations, it does not appear that a contract providing payments for life with guaranteed payments for a certain period, e.g., 10 years, would satisfy the proposed regulations. The reason for this is that payments for the stated period are guaranteed in all events, and thus are not made by reason of the death of one or more individuals. Perhaps the final regulations will clarify this issue.

The preamble to the proposed regulations states that they do not apply to an annuity contract issued by other than an insurance company which is not a debt instrument. The preamble indicates that an annuity will be considered a debt instrument for this purpose if it provides for a "guaranteed return." It appears that an annuity contract without a surrender or commutation right, guaranteed maturity value, or guaranteed payment stream would not provide a guaranteed return, and thus would not be a debt instrument subject to the proposed regulations. The preamble states, "(f)or example, that an annuity contract under which payments are wholly contingent on the continued life of an individual generally is not a debt instrument for federal income tax purposes." It should be noted, however, that the preamble provides further that an annuity without a guaranteed return will nevertheless be considered a debt instrument for this purpose if a return is guaranteed by another instrument (e.g., where an annuity that is not a debt instrument is issued in combination with a life insurance contract that, together, effectively provide for a guaranteed return).

The proposed regulations are effective for annuity contracts which are held on or after the date that is 30 days after the final regulations are published in the Federal Register. Also, the proposed regulations do not apply to annuity contracts purchased prior to April 7, 1995 (i.e., the date the proposed regulations were published in the Federal Register), but do apply to any additional investment in a contract made on or after that date, unless the investment is required under a binding contractual obligation entered into prior to that date. See Prop. Treas. Reg. 1.1275-1(d)(2)(iii).

In short, the proposed regulations do not apply to an annuity contract issued by other than an insurance company which is (1) purchased prior to April 7, 1995 (assuming no additional premiums are paid after that date), or (2) purchased prior to the effective date of the final regulations but which is not held on that date.

A public hearing on the proposed regulations has been scheduled for August 8, 1995, at the National Office of theInternal Revenue Service in Washington, D.C. Hence, there is more to come regarding the application of the annuity exception under Code section 1275(a)(1)(B)(i) to "annuities" issued by other than insurance companies.

I hope that your readers find this update helpful.

Mark E. Griffin
Davis & Harman
Washington, D.C.

American Society of CLU & ChFC

Future National Conference Schedule

1996	Dallas, TX Loews Anatole	October 9-12
1997	San Diego, CA San Diego Marriott Hotel and Marina	October 5-8
1998	Philadelphia, PA Philadelphia Marriott	October 4-7
1999	Orlando, FL Marriott World Cntr.	October 13-16

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