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Contact Person:

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Legend

Taxpayer 1 =

Taxpayer 2 =

Contract[s] =

State 1 =

State 2 =

a =

b =

Company =

c account =

d =

e Separate Account =

f Separate Account =

g value =

h value =

i payment option =

j payment option =

k year =
Program =

L Form =

Method M =

Method N =

Method O =

Dear

This is in response to your September 1, 1999 letter and subsequent correspondence requesting rulings that each Taxpayer should treat each automatic payment made pursuant to a systematic withdrawal program adopted with respect to certain deferred variable annuity contracts as part of a series of “substantially equal periodic payments” within the meaning of Internal Revenue Code § 72(q)(2)(D) for purposes of satisfying the Taxpayers’ reporting obligations with respect to the Contracts under § 6047(d).

Facts

In General

Taxpayers 1 and 2 are stock life insurance companies organized and operated under the laws of States 1 and 2, respectively. Taxpayer 1 is licensed to engage in the life insurance and annuity business in a states and in b. Taxpayer 2 is licensed to engage in the life insurance and annuity business in State 2. Taxpayer 2 is a wholly owned subsidiary of Taxpayer 1, which, in turn, is a wholly owned subsidiary of Company. Together all three join in the filing of a consolidated federal income tax return.

The Contracts are non-participating, flexible premium, variable deferred annuity contracts issued by Taxpayers 1 and 2. The Contracts are issued on both a qualified and nonqualified basis for retirement savings or other long term savings purposes. Except as explained herein, the Contracts issued by Taxpayers 1 and 2 are substantially identical in all respects material to this ruling request.

Under the Contracts’ terms, premiums may be paid at any time prior to the annuity starting date. The Contract holder may allocate contract values (premiums and the earnings thereon) among c account options, and d options. Each d option

corresponds to a portfolio of the e separate account or the f separate account respectively (collectively referred to as the separate accounts). The portfolios of the separate accounts, in turn, purchase shares of a corresponding series of a trust that is a regulated investment company for federal income tax purposes.

Before the annuity starting date, the contract value of a contract equals the sum of the g value and the h value.

Settlement Provisions

The Contract holder is required to select an annuity starting date and an i payment option (referred to as a j payment option in Taxpayer 2's contracts). The Contract holder may change, subject to certain rules, the annuity starting date and the payment options up to seven days before the annuity starting date. The Contract holder may elect one of the following payment options:

(1) a life income annuity,
(2) a joint and survivor annuity,
(3) a life annuity with 120 or 240 monthly payments guaranteed,
(4) an income for a specified period (5 to 30 years), or,
(5) any other payment option agreed to by Taxpayers 1 and 2

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On the annuity starting date the Contract holder may choose to receive payments from the c accounts, the separate accounts, or both.

Withdrawals

Prior to the annuity starting date the Contract holder may withdraw all or a portion of the value of a contract. Withdrawals and any surrender charges applicable will be deducted from the value of a contract in proportion to their allocation among the c account options and d options, unless the Contract holder chooses a different allocation method.

A surrender charge may apply to certain withdrawals. The surrender charge will vary in amount depending upon the k year of the premium at the time of withdrawal. For purposes of determining the surrender charge, withdrawals will be allocated first to earnings, if any (which may be withdrawn free of a surrender charge), and then to premiums on a first-in, first-out basis so that all withdrawals are allocated to premiums to which the lowest surrender charge applies.

Systematic Withdrawal Program

Taxpayers 1 and 2 have each developed a systematic withdrawal program called the Program, which each intends to offer to qualified and nonqualified Contract holders. Under the Program, a Contract holder can arrange to have automatic payments sent to

the Contract holder periodically while the Contract holder's contract is still in the accumulation phase, i.e., prior to the annuity starting date. Unless the Contract holder chooses to terminate or modify his or her participation in the Program, the Company will continue to make these automatic payments to the Contract holder until the Contract holder's account value is exhausted. The Contract holder can elect to have automatic payments made annually, semi-annually, quarterly or monthly.

To participate in the Program, a Contract holder will be required to submit to the Company an L Form. The L Form requires each Contract holder to specify from which c account and/or d options the automatic payments are to be made. For example, the Contract holder may specify that automatic payments are to be made only from the c account options. If the Contract holder does not specify from which c account or d options the automatic payments are to be made, the Company will withdraw them from each c account and each d option on a pro-rata basis.

Additionally, the L Form requires the Contract holder to elect how the automatic payments will be calculated. The Companies will offer three methods, which correspond to the three methods described in Q&A-12 of Notice 89-25, 1989-1 C.B. 662 (describing three methods for calculating substantially equal periodic payments for purposes of § 72(t)). The three methods are (1) Method M, (2) Method N, and (3) Method O. Each is described below.

Method M

Method M is a method that would be acceptable for purposes of calculating the minimum distributions required under § 401(a)(9). Specifically, Taxpayers 1 and 2 will use the method described in proposed regulation § 1.401(a)(9)-1, Q&A F-1[1] to calculate the automatic payment under the life expectancy method. Proposed regulation § 1.401(a)(9)-1, Q&As F-1 and F-5 provide that where the account balance of a plan is to be distributed over the life expectancy of an employee, the minimum required distribution is determined by dividing such account balance, generally determined as of the last day of the preceding calendar year, by the employee's life expectancy (as set out in regulation § 1.72-9, Table V). Taxpayers 1 and 2 will divide the contract value (as of the last day of the preceding calendar year) by the applicable life expectancy as set out in Table V of regulation § 1.72-9 (or the joint life and last survivor expectancy of the Contract holder and beneficiary as set out in Table VI of regulation § 1.72-9).

Method N

Under Method N, Taxpayers 1 and 2 will calculate the automatic payment as the

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[1] According to the preamble, Taxpayers may rely on proposed regulation § 1.401(a)(9)-1 for guidance pending the issuance of final regulations. See 1987-2 C.B. 884 .

amount necessary to amortize the contract value over a number of years equal to the life expectancy of the Contract holder or the joint life and last survivor expectancy of the Contract holder and beneficiary with life expectancies determined in accordance with proposed regulation § 1.401(a)(9)-1, based on an assumed interest rate equal to either (1) 120 percent of the Federal midterm rate in effect under § 1274(d)(1) or (2) 120 percent of the Federal long term rate in effect under § 1274(d)(1). Taxpayers 1 and 2 will determine a Contract holder's life expectancy in the year of distribution by using Table V of regulation § 1.72-9. They will determine the joint and last survivor life expectancy of a Contract holder and beneficiary by using Table VI of regulation § 1.72-9.

Method O

Under Method O, Taxpayers 1 and 2 will calculate the automatic payment as the amount obtained by dividing the contract value by an annuity factor (the present value of an annuity of $1 per year beginning at the Contract holder's age attained in the first distribution year and continuing for the life of the Contract holder). The annuity factor will be derived using the UP-1984 Mortality Table in the case of a single life (or in the case of joint lives, the Life Table 80 CNSMT) and an assumed interest rate equal to either (1) 120 percent of the Federal midterm rate in effect under § 1274(d)(1) or (2) 120 percent of the Federal long term rate in effect under § 1274(d)(1).

Each Taxpayer makes the following representations:

(1) the Contracts constitute annuity contracts for federal income tax purposes;

(2) if a Contract holder elects to have the automatic payment calculated according to Method M, the Company will use a method that is acceptable for purposes of calculating the minimum distribution required under § 401(a)(9); and,

(3) If a Contract holder wishes to participate in the systematic withdrawal program, the Contract holder must request that his/her entire contract value be applied to the Program. That Program does not allow for the allocation of anything less than the Contract holder's entire contract value.

Ruling Requested

Taxpayer 1 and 2 each should treat each automatic payment as part of a series of "substantially equal periodic payments" within the meaning of § 72(q)(2)(D) for purposes of satisfying the Companies' reporting obligations with respect to the Contracts under § 6047(d).

Law and Analysis

Section 72(q)

The Code imposes a "penalty tax" equal to ten percent of the amount received which is includible in gross income on certain premature or early distributions under annuity contracts. If the annuity contract is a "nonqualified" annuity contract, that penalty tax is imposed under § 72(q)(1). If it is a "qualified" contract (e.g., a § 403(b) annuity contract or an individual retirement annuity under § 408(b)), that penalty tax is imposed under § 72(t). The § 72(q)(1) penalty tax is imposed on all amounts received under an annuity contract, whether or not received as an annuity, unless the amount satisfies one of the exceptions set forth in § 72(q)(2).

Section 72(q)(2)(A) provides an exception to the penalty tax imposed by § 72(q)(1) for distributions made on or after the date on which the taxpayer attains age 59-½. If distributions are made before a taxpayer attains age 59-½, § 72(q)(2)(D) provides another exception for a distribution which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary.

Neither the Code nor the regulations define the term "substantially equal" as used in the § 72(q)(2)(D) exception. As originally enacted in 1982, § 72(q)(2)(D) provided that the penalty tax under § 72(q)(1) would not apply to a distribution which was "one of a series of substantially equal periodic payments made for the life of a taxpayer or . . . at least 60 months after the annuity starting date."[2] The Joint Committee Blue Book Explanation of § 72(q)(2) states that,

> The requirement that the amount be paid out as one of a series of 'substantially equal' periodic payments is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same.[3]

Section 1123(b)(2) of the Tax Reform Act of 1986, Pub. L. No. 99-514, (the "1986 Act") amended § 72(q)(2)(D) to state that a distribution satisfies that exception if it is "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or the joint life expectancies) of such taxpayer and his beneficiary."

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[2] See section 265(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248.

[3] Staff of the Joint Comm. on Tax'n, 97th Cong. 2d Sess., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, 364 (1982).

The legislative history of the 1986 amendment to § 72(q)(2)(D) states that:

> an exemption from the tax is provided for any distribution that is part of a scheduled series of substantially equal periodic payments (made not less frequently than annually) for the life of the participant (or the joint lives of the participant and the participant's beneficiary).[4]

That legislative history provides as an example of a scheduled series of payments "distributions under a life annuity to a 50-year-old participant under a qualified plan under which normal retirement occurs after 30 years of service."[5]

The Joint Committee Explanation of the 1986 Act states [p. 659]:

> In making both the TEFRA and 1984 Act changes to annuity provisions, Congress indicated its view that deferral of tax on investment income on annuities is justified only by the retirement savings purposes of annuities. Hence many of the rules for annuities now conform generally to those for qualified pension plans and IRAs.

The amendments in the 1986 Act modified the then existing penalty tax and the exception to the penalty tax for early withdrawals, provided for a recapture rule, and adopted a ten percent penalty tax for early distributions from annuities. A portion of the legislative history of that Act indicated that:

> In general, the committee believes that the additional income tax on early withdrawals should be the same for all tax-favored retirement savings arrangements and should be increased so that the additional tax serves, in most cases, to recapture a significant portion of the benefits of deferral of tax on income.[6]

In order to qualify under § 72(q)(2)(D), an automatic payment in the present case must be part of a series of periodic payments and those payments must be "substantially equal" payments. By participating in the Program, the Contract holder agrees that, so long as the Contract holder does not modify or terminate his or her participation in the Program, the relevant Taxpayer will automatically pay out his or her entire contract value in a scheduled series of annual, semi-annual, quarterly, or monthly

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[4] See H.R. Rep. No. 426, 99th Cong., 1st Sess. 730 (1986); H.R. Rep. No. 841 (Vol. II), 99th Cong., 2d Sess. II-456 (1986).

[5] Id.

[6] See H.R. Rep. No. 426, 99th Cong., 1st Sess. 704 (1986).

payments.[7] Thus, each automatic payment is one of a sequence of payments the Contract holder is scheduled to receive.

The Program provides that the automatic payments will be calculated under one of three methods: Method M, Method N, or Method O.

Under Method M, Taxpayers 1 and 2 calculate the automatic payment by dividing the contract value (as of the last day of the preceding calendar year) by the applicable life expectancy as set out in Table V of regulation § 1.72-9 (or the joint life and last survivor expectancy of the Contract holder and beneficiary as set out in Table VI of regulation § 1.72-9).

Under Method N, Taxpayers 1 and 2 calculate the automatic payment by amortizing the Contract holder's contract value over a number of years equal to the life expectancy of the Contract holder or the joint life and last survivor expectancy of the Contract holder and beneficiary, based on an assumed interest rate equal to either (1) 120 percent of the Federal midterm rate in effect under § 1274(d)(1) or (2) 120 percent of the Federal long term rate in effect under § 1274(d)(1). Life expectancies will be determined using Table V of regulation § 1.72-9, or Table VI in the case of joint and last survivor life expectancy).

Under Method O, Taxpayers 1 and 2 will compute the automatic payment by dividing the Contract holder's contract value by an annuity factor, which will be determined based on the UP-1984 Mortality Table in the case of a single life (or in the case of joint lives, the Life Table 80 CNSMT) and an assumed interest rate equal to either (1) 120 percent of the Federal midterm rate in effect under § 1274(d)(1) or (2) 120 percent of the Federal long term rate in effect under § 1274(d)(1).

In the present case, we conclude that the automatic payments computed under Method M, Method N or Method O are "substantially equal payments" within the meaning of § 72(q)(2)(D).

Reporting Obligation Under § 6047

Section 6047(d) requires a person that issues any contract under which "designated distributions" may be made, to make returns and reports regarding the contract to the Secretary of the Treasury, to the participants and beneficiaries of the

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[7] Under § 72(q)(3)(B), if the series of payments is subsequently modified (other than by death or disability) before the later of the close of the 5-year period beginning on the date of the first payment or the time the taxpayer attains age 59 ½, the taxpayer's tax for the first taxable year in which such modification occurs shall be increased by an amount equal to the tax that would have been imposed (but for § 72(q)(2)(D)) plus interest for the deferral period.

contract, and to such other persons as may be prescribed in forms or regulations. Each year the Service issues forms used for reporting purposes such as Form 1099-R and accompanying instructions.

Section 3405(e)(1)(A) defines a "designated distribution" as any distribution or payment from or under: (i) an employer deferred compensation plan; (ii) an individual retirement plan (as defined in § 7701(a)(37)); or, (iii) a commercial annuity. Section 3405(e)(6) defines a commercial annuity as "an annuity, endowment, or life insurance contract issued by an insurance company licensed to do business under the laws of any State." Because the contracts in the present case are commercial annuities, Taxpayers 1 and 2 are required to report distributions under the contracts pursuant to § 6047(d). For the reasons expressed above, it should do so by treating automatic payments under Method M, Method N and Method O as substantially equal periodic payments within the meaning of § 72(q)(2)(D).

The rulings 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. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and Products)

By: /s/ ______________________________

Mark Smith
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