Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–1: Definitions.

T.D. 8754

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Debt Instruments With Original Issue Discount; Annuity Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the federal income tax treatment of certain annuity contracts. The regulations determine which of these contracts are taxed as debt instruments for purposes of the original issue discount provisions of the Internal Revenue Code. The regulations provide needed guidance to owners and issuers of these contracts.

DATES: *Effective date:* The regulations are effective February 9, 1998.

Applicability dates: For dates of applicability, see §1.1275–1(j)(8).

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SUPPLEMENTARY INFORMATION:

Background

Sections 163(e) and 1271 through 1275 of the Internal Revenue Code (Code) provide rules for the treatment of debt instruments that have original issue discount (OID).

On February 2, 1994, the IRS and Treasury published in the **Federal Register** (59 F.R. 4799) final regulations under the OID provisions. On April 7, 1995, the IRS published in the **Federal Register** (60 F.R. 17731) a notice of proposed rulemaking relating to the federal income tax treatment of annuity contracts that are not issued by insurance companies subject to tax under subchapter L of the Code. The proposed regulations treat certain of these annuity contracts as debt instruments for purposes of the OID provisions.

The IRS received a number of written comments on the proposed regulations. In addition, on August 8, 1995, the IRS held a public hearing on the proposed regulations. The proposed regulations, with certain changes in response to comments, are adopted as final regulations. The comments and changes are discussed below.

Explanation of Provisions

Certain Annuity Contracts

The OID provisions generally apply to issuers and holders of debt instruments. The term *debt instrument* means any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law. See section 1275(a)(1) and §1.1275–1(d).

Section 1275(a)(1)(B) excepts two types of annuity contracts from the definition of *debt instrument* (and, therefore, from the OID provisions). First, section 1275(a)(1)(B)(i) excepts an annuity contract to which section 72 applies if the contract "depends (in whole or in substantial part) on the life expectancy of 1 or more individuals." Second, section 1275(a)(1)(B)(ii) excepts an annuity contract to which section 72 applies if the contract is issued by "an insurance company subject to tax under subchapter L" and the circumstances of the contract's issuance meet certain criteria.

The proposed regulations address only the first exception, which is contained in section 1275(a)(1)(B)(i). Under the proposed regulations, an annuity contract qualifies for the exception in section 1275(a)(1)(B)(i) only if all payments under the contract are periodic payments that: (1) are made at least annually for the life (or lives) of one or more individuals; (2) do not increase at any time during the life of the contract; and (3) are part of a series of payments that begins within one year of the date of the initial investment in the contract. An annuity contract that is otherwise described in the preceding sentence, however, does not fail to qualify for the exception in section 1275(a)(1)(B)(i) merely because it also provides for a payment (or payments) made by reason of the death of one or more individuals. Thus, under the proposed regulations, the exception in section 1275(a)(1)(B)(i) applies only to an immediate annuity contract with level (or decreasing) payments for the life (or lives) of one or more individuals. No deferred annuity contract qualifies for the exception.

Several commentators questioned the approach of the proposed regulations. In particular, they contended that the exception in section 1275(a)(1)(B)(i) should not be limited to those annuity contracts that require periodic payments to begin within one year of the date of the initial investment in the contract. That is, deferred annuities, if dependent in whole or substantial part on an individual's (or several individuals') survival, should also qualify for the exception in section 1275(a)(1)(B)(i). Other commentators took issue with this point of view and contended that the proposed regulations should be finalized without substantial change.

After a careful review of this issue, the IRS and the Treasury have modified the regulations to eliminate the requirement that annuity distributions begin within one year of the date of the initial investment in the contract. Instead, as suggested by the legislative history, the final regulations interpret section 1275(a)(1)(B)(i) as excepting from the definition of *debt instrument* only those annuity contracts that contain terms ensuring that the life contingency under the contract is both "real and significant." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 887 (1984), 1984–3 (Vol. 2) C.B. 141. The Treasury and the IRS have determined that the life contingency under an annuity contract is "real and significant" within the meaning of the legislative history only if, on the day the contract is purchased, there is a high probability that total distributions under the contract will increase commensurately with the longevity of the individual (or individuals) over whose life (or lives) the distributions are to be made. (These individuals are hereinafter referred to as annuitants.) The final regulations, therefore, provide a two-pronged general rule: An annuity contract qualifies for the exception in section 1275(a)(1)(B)(i) only if it both: (1) provides for periodic distrib-

utions made at least annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and (2) contains no terms or provisions that can significantly reduce the probability that total distributions will increase commensurately with longevity.

The final regulations identify several types of terms and provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity. These terms and provisions include the availability of a cash surrender option, the availability of a loan secured by the contract, minimum payout provisions, maximum payout provisions, and provisions that allow decreasing payouts. Subject to limited exceptions, the presence of any of these terms or provisions causes an annuity contract to fail to qualify for the exception in section 1275(a)(1)(B)(i). The list of identified terms and provisions in the final regulations is not exclusive. A contract fails to qualify for the exception in section 1275(a)(1)(B)(i) if the contract contains any other term or provision that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity.

Cash Surrender Options and Loans Secured by the Contract

If the holder of an annuity contract can exchange or surrender all or part of the contract for a distribution or for distributions that are not contingent on life, the holder's decision whether, and when, to exchange or surrender the contract can render the life contingency insignificant. Similarly, if the holder of an annuity contract can borrow against the contract, the holder's decision whether, and when, to borrow can have a comparable effect. The final regulations, therefore, provide that, if either the issuer or a person acting in concert with the issuer explicitly or implicitly makes available either a cash surrender option or a loan secured by the contract, then the contract contains a term that can significantly reduce the probability that total distributions on the contract will increase commensurately with longevity. That availability, therefore, causes the contract to fail to qualify for the exception in section 1275(a)(1)(B)(i).

Minimum Payout Provisions

If an annuity contract guarantees that a minimum amount will be distributed regardless of the death of the individual (or individuals) over whose life (or lives) payments are to be made, the minimum amount is not subject to the life contingency. In addition, the larger the minimum amount relative to aggregate expected distributions over the remaining (joint) life expectancy of the annuitant (or annuitants), the less likely it is that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). A sufficiently large minimum amount renders the life contingency virtually meaningless. For example, consider a contract that provides for monthly distributions to begin on the annuity starting date and to extend for the longer of the life of the annuitant or 20 years, regardless of the annuitant's age. If the annuitant has a life expectancy as of the annuity starting date of 5 years, it is likely that distributions will be made for exactly 20 years, regardless of when the annuitant dies. In this case, although the form of the contract indicates that it depends on life, the existence of the minimum payout provision significantly reduces the probability that total distributions under the contract will depend on longevity.

Because the existence of a minimum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity, the existence of any such provision generally causes the contract to fail to qualify for the exception in section 1275(a)(1)(B)(i). The final regulations provide only two exceptions to this general rule. First, an annuity contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it contains a minimum payout provision that guarantees a death benefit no greater than the unrecovered consideration paid for the contract. Second, an annuity contract does not fail to be described in section 1275(a)(1)(B)(i) merely because the contract provides that, after annuitization, distributions may be guaranteed to continue for a term certain that is no longer than one-half of the period of time from the annuity starting date to the expected date of the "terminating death."

The terminating death is the annuitant death that, in general, causes annuity payments to cease under the contract. The expected date of the terminating death is determined as of the annuity starting date with respect to all then-surviving annuitants by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I). See Rev. Rul. 95–6, 1995–1 C.B. 80, for the applicable mortality table that is prescribed for this purpose as of January 8, 1998.

Maximum Payout Provisions

If an annuity contract provides that distributions will cease if an annuitant lives beyond a specified date, total distributions under the contract may fail to increase commensurately with longevity. If the specified date is relatively early (when compared to the annuitant's life expectancy as of the annuity starting date), its existence significantly reduces the probability that total distributions under the contract will increase commensurately with longevity. Conversely, if the specified date is very late (when compared to the annuitant's life expectancy as of the annuity starting date), its existence does not significantly reduce the probability that total distributions under the contract will increase commensurately with longevity. For example, consider an annuity contract that provides that distributions will be made for the life of the annuitant but in no event for more than 30 years. If the annuitant is a relatively young person, this maximum payout provision significantly attenuates the life contingency. On the other hand, if the annuitant has a life expectancy of 10 years on the annuity starting date, this maximum payout provision is unlikely to determine the total distributions.

Because the existence of a maximum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity, the final regulations provide that the existence of any maximum payout provision generally causes the contract to fail to qualify for the exception in section 1275(a)(1)(B)(i). There is a single exception to this general rule in cases where the period of time between the annuity starting date and the date after which (under the maximum pay-

out provision) no distributions will be made is at least twice as long as the period of time from the annuity starting date to the expected date of the terminating death.

Decreasing Payout Provisions

The connection between longevity and distributions under an annuity contract is apparent in the case of a contract that provides for equal annual distributions for life. For each year the annuitant lives, another equal distribution is made. If distributions decrease over time, this connection can become attenuated. Consider an annuity contract that provides for a distribution upon annuitization of $100,000 followed by annual distributions of $10 per year for life. Although this contract provides for periodic distributions for life, the pattern of the distributions causes the amount distributed to fail to adequately reflect longevity.

If the amount of distributions under an annuity contract during any contract year may be less than the amount of distributions during the preceding year, the final regulations provide that this possibility can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity. Thus, the existence of this possibility generally causes the contract to fail to qualify for the exception in section 1275(a)(1)(B)(i). There is a single exception to this general rule for certain variable distributions that are closely tied to investment experience, inflation, or similar fluctuating criteria. In these cases, because the provision can result in comparable increases in the amount of distributions, the possibility that the distributions may decline from year to year does not significantly reduce the probability that total distributions under the contract will increase commensurately with longevity.

Private and Charitable Gift Annuity Contracts

Several commentators expressed concerns that the proposed regulations, if finalized, would alter the tax treatment traditionally afforded private and charitable gift annuity contracts. Private annuity contracts are typically issued as consideration in intra-family transfers of property. Charitable gift annuity contracts are typically issued by charitable institutions in exchange for a transfer of cash or property greater in value than the annuity. Because these contracts may call for periodic distributions to begin more than one year after they are issued, there was concern that, under the proposed regulations, they might fail to qualify for the exception in section 1275(a)(1)(B)(i).

In many cases, distributions under private and charitable gift annuity contracts are entirely contingent on the survival of one individual (or a small number of individuals). These contracts are not indebtedness under general principles of federal income tax law and, therefore, are not within the definition of *debt instrument* in section 1275(a)(1)(A). For almost all other private and charitable gift annuities, the final regulations address the concern by removing the requirement that the distributions begin within one year of the date of the initial investment in the contract.

Annuity Contracts Issued by Foreign Insurance Companies

One commentator asked the IRS to clarify the treatment of annuity contracts issued by a foreign insurance company that does not engage in a trade or business within the United States. In particular, the commentator asked for guidance on whether such an annuity contract qualifies under section 1275(a)(1)(B)(ii), which provides a broad exception from the definition of *debt instrument* for certain annuity contracts issued by "an insurance company subject to tax under subchapter L." These regulations do not address the exception in section 1275(a)(1)(B)(ii). The Treasury and the IRS, however, welcome comments on the proper scope of that provision.

Certain Compensation Arrangements

Several commentators questioned whether the proposed regulations apply to certain compensation arrangements whose distributions are taxed under section 72. The timing rules of the OID provisions do not apply to compensation arrangements that are subject to other specific Code or regulations provisions. For example, if an arrangement is described in the first sentence of section 404(a) or in section 404(b) or if amounts under the arrangement are includible under sections 83, 403, or 457, or under §1.61–2, the arrangement is not subject to the OID timing provisions. See also §§1.1273–2(d) and 1.1274–1(a), under which a nonpublicly traded debt instrument issued for services has an issue price equal to its stated redemption price at maturity and, therefore, has no OID.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury department participated in developing these regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "Sections 1.1271–1 through 1.1274–5" and "Sections 1.1275–1 through 1.1275–5" and adding the following entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1271–1 also issued under 26 U.S.C. 1275(d).

Section 1.1272–1 also issued under 26 U.S.C. 1275(d).

Section 1.1272–2 also issued under 26 U.S.C. 1275(d).

Section 1.1272–3 also issued under 26 U.S.C. 1275(d).

Section 1.1273–1 also issued under 26

U.S.C. 1275(d).
Section 1.1273–2 also issued under 26 U.S.C. 1275(d).
Section 1.1274–1 also issued under 26 U.S.C. 1275(d).
Section 1.1274–2 also issued under 26 U.S.C. 1275(d).
Section 1.1274–3 also issued under 26 U.S.C. 1275(d).
Section 1.1274–4 also issued under 26 U.S.C. 1275(d).
Section 1.1274–5 also issued under 26 U.S.C. 1275(d). * * *
Section 1.1275–1 also issued under 26 U.S.C. 1275(d).
Section 1.1275–2 also issued under 26 U.S.C. 1275(d).
Section 1.1275–3 also issued under 26 U.S.C. 1275(d).
Section 1.1275–4 also issued under 26 U.S.C. 1275(d).
Section 1.1275–5 also issued under 26 U.S.C. 1275(d). * * *

Par. 2. Section 1.1271–0 is amended by adding entries for paragraphs (i) through (j)(8) to §1.1275–1 to read as follows:

§1.1271–0 Original issue discount; effective dates; table of contents.

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§1.1275–1 Definitions.

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(i) [Reserved]

(j) Life annuity exception under section 1275(a)(1)(B)(i).

(1) Purpose.

(2) General rule.

(3) Availability of a cash surrender option.

(4) Availability of a loan secured by the contract.

(5) Minimum payout provision.

(6) Maximum payout provision.

(7) Decreasing payout provision.

(8) Effective dates.

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Par. 3. Section 1.1275–1 is amended by:

1. Revising the first sentence of paragraph (d).

2. Adding and reserving paragraph (i).

3. Adding paragraph (j).

The revision and additions read as follows:

§1.1275–1 Definitions.

* * * * *

(d) *Debt instrument.* Except as provided in section 1275(a)(1)(B) (relating to certain annuity contracts; see paragraph (j) of this section), debt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan). * * *

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(i) [Reserved]

(j) *Life annuity exception under section 1275(a)(1)(B)(i)*—(1) *Purpose.* Section 1275(a)(1)(B)(i) excepts an annuity contract from the definition of *debt instrument* if section 72 applies to the contract and the contract depends (in whole or in substantial part) on the life expectancy of one or more individuals. This paragraph (j) provides rules to ensure that an annuity contract qualifies for the exception in section 1275(a)(1)(B)(i) only in cases where the life contingency under the contract is real and significant.

(2) *General rule*—(i) *Rule.* For purposes of section 1275(a)(1)(B)(i), an annuity contract depends (in whole or in substantial part) on the life expectancy of one or more individuals only if—

(A) The contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and

(B) The contract does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

(ii) *Terminology.* For purposes of this paragraph (j):

(A) *Contract.* The term *contract* includes all written or unwritten understandings among the parties as well as any person or persons acting in concert with one or more of the parties.

(B) *Annuitant.* The term *annuitant* refers to the individual (or reasonable number of individuals) referred to in paragraph (j)(2)(i)(A) of this section.

(C) *Terminating death.* The phrase *terminating death* refers to the annuitant death that can terminate periodic distributions under the contract. (See paragraph (j)(2)(i)(A) of this section.) For example, if a contract provides for periodic distributions until the later of the death of the last-surviving annuitant or the end of a term certain, the terminating death is the death of the last-surviving annuitant.

(iii) *Coordination with specific rules.* Paragraphs (j)(3) through (7) of this section describe certain terms and conditions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). If a term or provision is not specifically described in paragraphs (j)(3) through (7) of this section, the annuity contract must be tested under the general rule of paragraph (j)(2)(i) of this section to determine whether it depends (in whole or in substantial part) on the life expectancy of one or more individuals.

(3) *Availability of a cash surrender option*—(i) *Impact on life contingency.* The availability of a cash surrender option can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the availability of any cash surrender option causes the contract to fail to be described in section 1275(a)(1)(B)(i). A cash surrender option is available if there is reason to believe that the issuer (or a person acting in concert with the issuer) will be willing to terminate or purchase all or a part of the annuity contract by making one or more payments of cash or property (other than an annuity contract described in this paragraph (j)).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (j)(3):

Example 1. (i) *Facts.* On March 1, 1998, X issues a contract to A for cash. The contract provides that, effective on any date chosen by A (the annuity starting date), X will begin equal monthly distributions for A's life. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, A's age on that date, and permanent purchase rate guarantees contained in the contract. The contract also provides that, at any time before the annuity starting date, A may surrender the contract to X for the account value less a surrender charge equal to a declining percentage of the account value. For this purpose, the initial account value is equal to the cash invested. Thereafter, the account value increases annually by at least a minimum guaranteed rate.

(ii) *Analysis.* The ability to obtain the account value less the surrender charge, if any, is a cash surrender option. This ability can significantly reduce

the probability that total distributions under the contract will increase commensurately with A's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* On March 1, 1998, X issues a contract to B for cash. The contract provides that beginning on March 1, 1999, X will distribute to B a fixed amount of cash each month for B's life. Based on X's advertisements, marketing literature, or illustrations or on oral representations by X's sales personnel, there is reason to believe that an affiliate of X stands ready to purchase B's contract for its commuted value.

(ii) *Analysis.* Because there is reason to believe that an affiliate of X stands ready to purchase B's contract for its commuted value, a cash surrender option is available within the meaning of paragraph (j)(3)(i) of this section. This availability can significantly reduce the probability that total distributions under the contract will increase commensurately with B's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

(4) *Availability of a loan secured by the contract*—(i) *Impact on life contingency.* The availability of a loan secured by the contract can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the availability of any such loan causes the contract to fail to be described in section 1275(a)(1)(B)(i). A loan secured by the contract is available if there is reason to believe that the issuer (or a person acting in concert with the issuer) will be willing to make a loan that is directly or indirectly secured by the annuity contract.

(ii) *Example.* The following example illustrates the rules of this paragraph (j)(4):

Example. (i) *Facts.* On March 1, 1998, X issues a contract to C for $100,000. The contract provides that, effective on any date chosen by C (the annuity starting date), X will begin equal monthly distributions for C's life. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, C's age on that date, and permanent purchase rate guarantees contained in the contract. From marketing literature circulated by Y, there is reason to believe that, at any time before the annuity starting date, C may pledge the contract to borrow up to $75,000 from Y. Y is acting in concert with X.

(ii) *Analysis.* Because there is reason to believe that Y, a person acting in concert with X, is willing to lend money against C's contract, a loan secured by the contract is available within the meaning of paragraph (j)(4)(i) of this section. This availability can significantly reduce the probability that total distributions under the contract will increase commensurately with C's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

(5) *Minimum payout provision*—(i) *Impact on life contingency.* The existence of a minimum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of any minimum payout provision causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Definition of minimum payout provision.* A minimum payout provision is a contractual provision (for example, an agreement to make distributions over a term certain) that provides for one or more distributions made—

(A) After the terminating death under the contract; or

(B) By reason of the death of any individual (including distributions triggered by or increased by terminal or chronic illness, as defined in section 101(g)(1)(A) and (B)).

(iii) *Exceptions for certain minimum payouts*—(A) *Recovery of consideration paid for the contract.* Notwithstanding paragraphs (j)(2)(i)(A) and (j)(5)(i) of this section, a contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it provides that, after the terminating death, there will be one or more distributions that, in the aggregate, do not exceed the consideration paid for the contract less total distributions previously made under the contract.

(B) *Payout for one-half of life expectancy.* Notwithstanding paragraphs (j)(2)(i)(A) and (j)(5)(i) of this section, a contract does not fail to be described in section 1275(a)(1)(B)(i) merely because it provides that, if the terminating death occurs after the annuity starting date, distributions under the contract will continue to be made after the terminating death until a date that is no later than the halfway date. This exception does not apply unless the amounts distributed in each contract year will not exceed the amounts that would have been distributed in that year if the terminating death had not occurred until the expected date of the terminating death, determined under paragraph (j)(5)(iii)(C) of this section.

(C) *Definition of halfway date.* For purposes of this paragraph (j)(5)(iii), the halfway date is the date halfway between the annuity starting date and the expected date of the terminating death, determined as of the annuity starting date, with respect to all then-surviving annuitants. The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I).

(iv) *Examples.* The following examples illustrate the rules of this paragraph (j)(5):

Example 1. (i) *Facts.* On March 1, 1998, X issues a contract to D for cash. The contract provides that, effective on any date D chooses (the annuity starting date), X will begin equal monthly distributions for the greater of D's life or 10 years, regardless of D's age as of the annuity starting date. The amount of each monthly distribution will be no less than an amount based on the contract's account value as of the annuity starting date, D's age on that date, and permanent purchase rate guarantees contained in the contract.

(ii) *Analysis.* A minimum payout provision exists because, if D dies within 10 years of the annuity starting date, one or more distributions will be made after D's death. The minimum payout provision does not qualify for the exception in paragraph (j)(5)(iii)(B) of this section because D may defer the annuity starting date until his remaining life expectancy is less than 20 years. If, on the annuity starting date, D's life expectancy is less than 20 years, the minimum payout period (10 years) will last beyond the halfway date. The minimum payout provision, therefore, can significantly reduce the probability that total distributions under the contract will increase commensurately with D's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (j)(5)(iv) except that the monthly distributions will last for the greater of D's life or a term certain. D may choose the length of the term certain subject to the restriction that, on the annuity starting date, the term certain must not exceed one-half of D's life expectancy as of the annuity starting date. The contract also does not provide for any adjustment in the amount of distributions by reason of the death of D or any other individual, except for a refund of D's aggregate premium payments less the sum of all prior distributions under the contract.

(ii) *Analysis.* The minimum payout provision qualifies for the exception in paragraph (j)(5)(iii)(B) of this section because distributions under the minimum payout provision will not continue past the halfway date and the contract does not provide for any adjustments in the amount of distributions by reason of the death of D or any other individual, other than a guaranteed death benefit described in paragraph (j)(5)(iii)(A) of this section. Accordingly, the existence of this minimum payout provision does not prevent the contract from being described in section 1275(a)(1)(B)(i).

(6) *Maximum payout provision*—(i) *Impact on life contingency.* The existence of a maximum payout provision can significantly reduce the probability that total distributions under the contract will increase commensurately with the

longevity of the annuitant (or annuitants). Thus, the existence of any maximum payout provision causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Definition of maximum payout provision.* A maximum payout provision is a contractual provision that provides that no distributions under the contract may be made after some date (the termination date), even if the terminating death has not yet occurred.

(iii) *Exception.* Notwithstanding paragraphs (j)(2)(i)(A) and (j)(6)(i) of this section, an annuity contract does not fail to be described in section 1275(a)(1)(B)(i) merely because the contract contains a maximum payout provision, provided that the period of time from the annuity starting date to the termination date is at least twice as long as the period of time from the annuity starting date to the expected date of the terminating death, determined as of the annuity starting date, with respect to all then-surviving annuitants. The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under section 417(e)(3)(A)(ii)(I).

(iv) *Example.* The following example illustrates the rules of this paragraph (j)(6):

Example. (i) *Facts.* On March 1, 1998, X issues a contract to E for cash. The contract provides that beginning on April 1, 1998, X will distribute to E a fixed amount of cash each month for E's life but that no distributions will be made after April 1, 2018. On April 1, 1998, E's life expectancy is 9 years.

(ii) *Analysis.* A maximum payout provision exists because if E survives beyond April 1, 2018, E will receive no further distributions under the contract. The period of time from the annuity starting date (April 1, 1998) to the termination date (April 1, 2018) is 20 years. Because this 20–year period is more than twice as long as E's life expectancy on April 1, 1998, the maximum payout provision qualifies for the exception in paragraph (j)(6)(iii) of this section. Accordingly, the existence of this maximum payout provision does not prevent the contract from being described in section 1275(a)(1)(B)(i).

(7) *Decreasing payout provision*—(i) *General rule.* If the amount of distributions during any contract year (other than the last year during which distributions are made) may be less than the amount of distributions during the preceding year, this possibility can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Thus, the existence of this possibility causes the contract to fail to be described in section 1275(a)(1)(B)(i).

(ii) *Exception for certain variable distributions.* Notwithstanding paragraph (j)(7)(i) of this section, if an annuity contract provides that the amount of each distribution must increase and decrease in accordance with investment experience, cost of living indices, or similar fluctuating criteria, then the possibility that the amount of a distribution may decrease for this reason does not significantly reduce the probability that the distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

(iii) *Examples.* The following examples illustrate the rules of this paragraph (j)(7):

Example 1. (i) *Facts.* On March 1, 1998, X issues a contract to F for $100,000. The contract provides that beginning on March 1, 1999, X will make distributions to F each year until F's death. Prior to March 1, 2009, distributions are to be made at a rate of $12,000 per year. Beginning on March 1, 2009, distributions are to be made at a rate of $3,000 per year.

(ii) *Analysis.* If F is alive in 2009, the amount distributed in 2009 ($3,000) will be less than the amount distributed in 2008 ($12,000). The exception in paragraph (j)(7)(ii) of this section does not apply. The decrease in the amount of any distributions made on or after March 1, 2009, can significantly reduce the probability that total distributions under the contract will increase commensurately with F's longevity. Thus, the contract fails to be described in section 1275(a)(1)(B)(i).

Example 2. (i) *Facts.* On March 1, 1998, X issues a contract to G for cash. The contract provides that, effective on any date G chooses (the annuity starting date), X will begin monthly distributions to G for G's life. Prior to the annuity starting date, the account value of the contract reflects the investment return, including changes in the market value, of an identifiable pool of assets. When G chooses the annuity starting date, G must also choose whether the distributions are to be fixed or variable. If fixed, the amount of each monthly distribution will remain constant at an amount that is no less than an amount based on the contract's account value as of the annuity starting date, G's age on that date, and permanent purchase rate guarantees contained in the contract. If variable, the monthly distributions will fluctuate to reflect the investment return, including changes in the market value, of the pool of assets. The monthly distributions under the contract will not otherwise decline from year to year.

(ii) *Analysis.* Because the only possible year-to-year declines in annuity distributions are described in paragraph (j)(7)(ii) of this section, the possibility that the amount of distributions may decline from the previous year does not reduce the probability that total distributions under the contract will increase commensurately with G's longevity. Thus, the potential fluctuation in the annuity distributions does not cause the contract to fail to be described in section 1275(a)(1)(B)(i).

(8) *Effective dates*—(i) *In general.* Except as provided in paragraph (j)(8)(ii) and (iii) of this section, this paragraph (j) is applicable for interest accruals on or after February 9, 1998 on annuity contracts held on or after February 9, 1998.

(ii) *Grandfathered contracts.* This paragraph (j) does not apply to an annuity contract that was purchased before April 7, 1995. For purposes of this paragraph (j)(8), if any additional investment in such a contract is made on or after April 7, 1995, and the additional investment is not required to be made under a binding contractual obligation that was entered into before April 7, 1995, then the additional investment is treated as the purchase of a contract after April 7, 1995.

(iii) *Contracts consistent with the provisions of FI–33–94, published at 1995–1 C.B. 920. See § 601.601(d)(2)(ii)(b) of this chapter.* This paragraph (j) does not apply to a contract purchased on or after April 7, 1995, and before February 9, 1998, if all payments under the contract are periodic payments that are made at least annually for the life (or lives) of one or more individuals, do not increase at any time during the term of the contract, and are part of a series of distributions that begins within one year of the date of the initial investment in the contract. An annuity contract that is otherwise described in the preceding sentence does not fail to be described therein merely because it also provides for a payment (or payments) made by reason of the death of one or more individuals.

Michael P. Dolan,
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Approved December 19, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

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