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INTERNAL REVENUE SERVICE
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OFFICE OF
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CC:FIP:4:BLandau
COR-117189-01

[REDACTED]

Attn: [REDACTED]

Dear [REDACTED]:

This is in reply to your letter dated December 4, 2000, concerning how to determine the amount includible in gross income when there has been a distribution from a nonqualified variable annuity prior to the annuity starting date. We have agreed that your concerns are appropriately answered by a general information letter.

You are concerned with an annuity contract acquired after August 13, 1982. Distributions prior to the annuity starting date from such annuities are considered amounts received under an annuity contract that are not received as annuities. Their taxation is determined under section 72(e) of the Internal Revenue Code.

In general, under section 72(e)(2)(B), each such nonannuity distribution is treated first as a payment of the income, if any, that has accumulated in the contract. The distribution will thus be includible in gross income as ordinary income until all of the income in the contract has been exhausted. Only then will the distribution be treated as a nontaxable return of investment in the contract (premiums paid).

For a variable annuity contract, the determination of whether income has accumulated in the contract is made by subtracting the investment in the entire contract from the cash value (without regard to surrender charges) of the entire contract. For example, consider a variable annuity with two subaccounts (investment choices), Fund A and Fund B. As of March 31, 2001, the values of Funds A and B and the allocations of premium payments to the two funds are reflected in the table below:

	Fund A	Fund B	Entire Annuity
Value 3/31/01	\$25,000	\$15,000	\$40,000
Premiums Paid	\$20,000	\$10,000	\$30,000
Income	\$5,000	\$5,000	\$10,000

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Now suppose that on March 31, 2001, Taxpayer, the owner of the annuity, withdraws \$6,000 from Fund A. One way of analyzing the distribution is to say that since only \$5,000 of income has been earned by Fund A, Taxpayer includes \$5,000 in gross income and treats the remaining \$1,000 of the distribution as a return of principal. This is not how the distribution is analyzed under the Code.

Instead, under section 72(e)(3)(A), the excess of the entire contract's cash value over the investment in the entire contract is computed. In our example, as of March 31, 2001, this amount is equal to \$10,000 (\$40,000 - \$30,000). Since the amount of the distribution (\$6,000) is less than this amount, the entire distribution is includible in gross income as ordinary income.

We also direct your attention to the so-called "penalty tax" for premature distributions from annuity contracts. In general, under section 72(q)(1), when a taxpayer receives any amount under an annuity contract, the taxpayer's income tax is increased by an amount equal to 10 percent of the portion of the distribution that is includible in gross income.

There are several exceptions to the general rule of section 72(q)(1). One of the exceptions is for distributions made on or after the date the taxpayer attains age 59 ½.

This exception may apply in certain cases notwithstanding that the annuity is owned by a trust, rather than an individual. Under sections 671-679 of the Code, the grantor of a trust may, in certain circumstances usually relating to the extent of the grantor's retained powers over the trust assets, be treated as the owner of all or a portion of the trust for federal income tax purposes. When a grantor is treated as the owner of the entire trust ("grantor trust"), the grantor must include items of income, deduction, and credit attributable to the trust in computing his or her taxable income and credits. The grantor also is considered to be the owner of the trust assets for federal income tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184.

Thus, if a grantor trust owns an annuity, the grantor is treated for federal income tax purposes as the owner of the annuity. If the grantor has attained age 59 ½, the grantor will not be liable for the "penalty tax" under section 72(q)(1).

This letter provides general information only and is not a written determination concerning the matters submitted to us or as to any other transaction. We hope this

