

## Internal Revenue Service

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Date:  
May 07, 2020

### Legend:

Parent =  
State =  
Taxpayer =

Dear \_\_\_\_\_ :

This letter responds to your submission requesting rulings under sections 72(q)(2) and 72(u)(1) of the Internal Revenue Code (the "Code") in the scenarios described below in which an annuity contract is issued to a trust. These rulings are requested so the Taxpayer may satisfy its reporting obligations under section 6047(d).

### **FACTS**

The Taxpayer is a life insurance company organized and operated under the laws of State. The Taxpayer is a subsidiary of the Parent and joins in the filing of a consolidated federal income tax return with the Parent on a calendar year basis using an accrual method of accounting.

The Taxpayer issues nonqualified deferred annuity contracts that may be fixed, indexed, or variable contracts, that contain customary, industry standard terms, and that are considered annuity contracts in accordance with the customary practice of life insurance companies (the "Contracts"). The Taxpayer regularly issues Contracts to both grantor trusts and non-grantor trusts in situations similar to those described below. The Taxpayer has information reporting obligations under section 6047(d) with respect to distributions or payments under the Contracts.

In the Grantor Trust Scenario, the Taxpayer issues a Contract to a grantor trust (i.e., a trust described in subpart E of part I of subchapter J (sections 671 through 679)) (the “Grantor Trust”) that was established by one individual (the “Grantor”). The beneficiaries of the Grantor Trust (each, a “Grantor Trust Beneficiary”) are an individual who is not the Grantor and a charitable organization. There are no contingent beneficiaries under the Grantor Trust. The Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (i.e., the person entitled to receive distributions under the Contract). The individual Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (i.e., the measuring life).

In the Non-Grantor Trust Scenario, the Taxpayer issues a Contract to a trust subject to tax under section 641 (the “Non-Grantor Trust”) that was established by one individual (the “Settlor”). The sole beneficiary of the Non-Grantor Trust (the “Non-Grantor Trust Beneficiary”) is an individual who is not the Settlor and who does not have a power exercisable by himself to vest trust income or corpus in himself as described in section 678. There are no contingent beneficiaries under the Non-Grantor Trust. The Non-Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (i.e., the person entitled to receive distributions under the Contract). The Non-Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (i.e., the measuring life).

## **REPRESENTATIONS**

The Taxpayer makes the following additional representations:

1. In the Grantor Trust Scenario, the Grantor will be considered the owner of the entire Grantor Trust under subpart E of part I of subchapter J.
2. In the Non-Grantor Trust Scenario, neither the Settlor nor any other person will be considered the owner of the Non-Grantor Trust under subpart E of part I of subchapter J, and the Non-Grantor Trust is a trust subject to tax under section 641.
3. Each Contract is an annuity contract under the law of the jurisdiction where issued.
4. Each Contract qualifies for treatment as an annuity contract for federal income tax purposes, including by complying with the requirements of section 72(s) and, where applicable, the requirements of section 817(h) and the “investor control” doctrine.
5. The sole annuitant named in each Contract is the “primary annuitant” within the meaning of section 72(s)(6)(B).
6. No Contract will be issued in a situation where an employer is the nominal owner of the Contract and the employer’s employees are the beneficial owners of

the Contract, including as part of any arrangement to provide deferred compensation to such employees.

## LAW

### Section 72

Section 72 prescribes the income tax treatment of amounts received under annuity contracts. Section 1.72-2(a) of the Income Tax Regulations provides that contracts under which amounts paid will be subject to section 72 include contracts that are considered to be annuity contracts in accordance with the customary practice of life insurance companies.

Section 72(q) provides, subject to certain exceptions, that if a taxpayer receives an amount under an annuity contract, such taxpayer's tax for the taxable year in which such amount is received is increased by 10 percent of the portion of such amount that is includible in gross income. The exceptions listed in section 72(q)(2) include situations where the distribution is:

- (A) made on or after the date on which the taxpayer attains age 59½ (section 72(q)(2)(A)),
- (B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)) (section 72(q)(2)(B)),
- (C) attributable to the taxpayer's becoming disabled within the meaning of section 72(m)(7) (section 72(q)(2)(C)), or
- (D) 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 or her designated beneficiary (section 72(q)(2)(D)).

Section 72(s) provides that a contract will not be treated as an annuity contract for federal income tax purposes unless, with certain exceptions, the contract provides for certain distributions in the event its holder dies before the entire interest in the contract is distributed. Under section 72(s)(1)(A), the contract must provide that if any holder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution being used as of the date of such death. Under section 72(s)(1)(B), the contract must also provide that if any holder dies before the annuity starting date, the entire interest in the contract will be distributed within five years after the date of such death. Exceptions apply when distributions after a holder's death are made to a designated beneficiary, including the surviving spouse of the deceased holder.

Section 72(s)(6)(A) provides that for certain purposes, if the holder of the contract is not an individual, then the primary annuitant is treated as the holder of the contract. Section 72(s)(6)(B) defines primary annuitant to be the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

Section 72(u)(1) generally provides that if an annuity contract is held by a person who is not a natural person, then such contract is not treated as an annuity contract for federal income tax purposes (other than subchapter L) and the income on such contract for any taxable year is treated as ordinary income received or accrued by the owner during such taxable year.

Section 72(u) was enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 1986-3 (Vol. 1) C.B. 1. The legislative history contains the following reasons for enacting section 72(u):

The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts can be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), the committee is concerned that the present-law treatment of deferred annuity contracts dilutes the effect of the nondiscrimination rules applicable to qualified pension plans.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 703 (1985), 1986-3 (Vol. 2) C.B. 1, 580.

The flush language of section 72(u)(1), however, provides that holding by a trust or other entity as an agent for a natural person is not taken into account. The legislative history contains the following explanation of this flush language:

In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. Thus, if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for Federal income tax purposes. However, the committee intends that, if an employer is the nominal owner of an annuity contract, the beneficial owners of which are employees, the contract will be treated as held by the employer. The committee intends this rule because it is concerned that the Internal Revenue Service would have difficulty monitoring compliance with the general rule that a deferred

annuity is not available on a tax-favored basis, to fund nonqualified deferred compensation.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 704 (1985), 1986-3 (Vol. 2) C.B. 1, 580.

Section 7701(a)(14) defines “taxpayer” to mean any person subject to any internal revenue tax.

### Trust Classification

Section 301.7701-4(a) of the Procedure and Administration Regulations provides that, in general, the term “trust” as used in the Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually, the beneficiaries of a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries may be the persons who created the trust, and the trust will be recognized as a trust under the Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Rev. Rul. 69-300, 1969-1 C.B. 167, concludes that an agreement creates a trust rather than an agency relationship if the trustee is vested with broad discretionary powers of administration and management.

United States v. Anderson, 132 F.2d 98 (6th Cir. 1942), involved the issue of whether an agreement between the taxpayer and a bank created a trust or an agency relationship. In that case, the bank could not invest or dispose of any corpus without the consent of the settlor and was relieved of all liability for any decline in the value of the corpus. The settlor had the power to vote any corporate stock held by the bank and could remove the bank and select a successor at any time. The court stated that while an agent undertakes to act on behalf of its principal and is subject to its control, a trustee usually has discretionary powers and acts for a term. Accordingly, because the bank did not have discretionary powers, the court held that the agreement created an agency relationship rather than a trust. See also City Nat'l Bank & Trust Co. v. United States, 109 F.2d 191 (7th Cir. 1940) (holding that no trust was formed where bank's investment decisions could be overridden by settlor and other evidence of managerial power was lacking).

### Non-Grantor Trust

Section 641(a) generally provides that the tax imposed by section 1(e) applies to the taxable income of estates or of any kind of property held in trust. Section 1.641(a)-0(b) provides that subparts A through D of part I of subchapter J (including section 641) have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners.

### Grantor Trust

Section 671 provides that when it is specified in subpart E of part I of subchapter J that the grantor or another person is treated as the owner of any portion of a trust, there will then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-3(a) provides that when a grantor or other person is treated under subpart E as the owner of any portion of a trust, there are included in computing such grantor's or other person's tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example, if a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), the grantor takes into account in computing the grantor's income tax liability all items of income, deduction, and credit (including capital gains and losses) to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as the owner.

Revenue Ruling 85-13, 1985-1 C.B. 184, provides that a grantor who is treated as the owner of the entire trust under section 671 is treated as the owner of the trust assets for federal income tax purposes. Therefore, a transfer of assets between the grantor and the trust is not recognized as a sale or exchange.

## **ANALYSIS**

### Grantor Trust Scenario

#### Sections 72(q)(2)(A), (C), (D)

Section 72(q) generally imposes an additional 10% tax on amounts received under an annuity contract that are includible in income unless certain exceptions apply. Sections 72(q)(2)(A), (C), and (D) respectively provide exceptions to the 10% additional tax if the distribution is made on or after the date the "taxpayer" attains age 59½, if the distribution is attributable to the "taxpayer's" becoming disabled, or if the distribution is part of a series of substantially equal periodic payments made for the life of the

“taxpayer” or the “taxpayer” and his or her designated beneficiary. Section 7701(a)(14) defines “taxpayer” to mean any person subject to any internal revenue tax.

Under the grantor trust rules, section 671 provides that when the grantor is treated as the owner of any portion of a trust, the grantor must include in computing his or her taxable income those items of income, deductions, and credits that are attributable to that portion of the trust. Section 1.671-3(a)(1) provides, in relevant part, that if a grantor is treated as the owner of an entire trust, the grantor takes into account in computing his or her income tax liability all items of income to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as owner of the trust.

In the Grantor Trust Scenario, the Grantor is the owner of the Grantor Trust for federal income tax purposes. As a consequence, the Grantor is required to include in income any income arising from the receipt by the Grantor Trust of distributions under the Contract. Accordingly, the Grantor is the “taxpayer” with respect to the Contract, and references to the “taxpayer” in sections 72(q)(2)(A), (C), and (D) are references to the Grantor.

#### Section 72(q)(2)(B)

Section 72(q)(2)(B) provides an exception to the 10% additional tax if the distribution is made on or after the death of the “holder” or, when the “holder” is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)). Section 72(s)(6)(B) defines the primary annuitant as the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

In the Grantor Trust Scenario, the Grantor Trust is the “holder” of the Contract because it is designated in the Contract as the owner of the Contract. The Grantor Trust is not an individual, however, so the exception provided in section 72(q)(2)(B) applies if the distribution is made on or after the death of the primary annuitant, as defined in section 72(s)(6)(B). In the Grantor Trust Scenario, the primary annuitant is the individual Grantor Trust Beneficiary. Thus, the exception provided in section 72(q)(2)(B) will apply in the Grantor Trust Scenario to distributions made on or after the death of the individual Grantor Trust Beneficiary.

#### Section 72(u)(1)

Section 72(u)(1) generally provides that an annuity contract is not treated as such for federal income tax purposes (other than subchapter L) if it is held by a person who is not a natural person. The flush language of section 72(u)(1), however, provides that holding by a trust or other entity as an agent for a natural person is not taken into account for this purpose.

A trustee generally has fiduciary obligations under trust documents and governing law that are inconsistent with it acting as an agent for the beneficiary of a trust. See, e.g., Restatement (Third) of Agency section 1.01 cmt. g (2018); Restatement (Third) of Trusts section 5(e) & cmt. e (2003); Restatement (Second) of Agency section 14B (1958). This principle also applies for federal income tax purposes. See, e.g., Rev. Rul. 69-300; United States v. Anderson, 132 F.2d 98 (6th Cir. 1942). Accordingly, the phrase “as an agent” in the flush language of section 72(u)(1) pertains only to “other entity.” It does not pertain to “trust.” Thus, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

In the Grantor Trust Scenario, the Grantor Trust is the “holder” of the Contract within the meaning of section 72(u)(1) because it is designated in the Contract as the owner of the Contract.

The Grantor is treated as the owner of the entire Grantor Trust, and as a consequence, the Grantor is also treated as the owner of the Contract for federal income tax purposes. See Rev. Rul. 85-13. The Grantor Trust is holding the Contract for the Contract’s tax owner, the Grantor, who is a natural person. Accordingly, the holding of the Contract by the Grantor Trust is not taken into account for purposes of section 72(u)(1).

This determination is consistent with the purpose for adopting section 72(u). Section 72(u) was adopted to encourage employers to offer benefits to employees under qualified pension plans, which are subject to certain restrictions and generally must be made available to a wide class of employees, as opposed to offering deferred compensation to a limited class of employees that is funded by deferred annuity contracts. Because the Contract in the Grantor Trust Scenario is not issued in the employment context, the arrangement does not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

### Non-Grantor Trust Scenario

#### Sections 72(q)(2)(A), (C), (D)

As discussed above, sections 72(q)(2)(A), (C), and (D) provide exceptions to the 10% additional tax imposed by section 72(q)(1) if a distribution is made on or after the date the “taxpayer” attains age 59½, if the distribution is attributable to the “taxpayer’s” becoming disabled, or if the distribution is part of a series of substantially equal periodic payments made for the life of the “taxpayer” or the “taxpayer” and his or her designated beneficiary.

Unlike grantor trusts, a non-grantor trust is potentially subject to federal income tax. (Although the tax burden may be passed through to a non-grantor trust’s beneficiaries, the non-grantor trust is initially subject to the tax and must claim a



deduction to eliminate any income tax liability at the trust level.) In the Non-Grantor Trust Scenario, the Non-Grantor Trust is required to include in income any income arising from the receipt by the Non-Grantor Trust of distributions under the Contract. Accordingly, the Non-Grantor Trust is the “taxpayer” with respect to the Contract, and references to the “taxpayer” in sections 72(q)(2)(A), (C), and (D) are references to the Non-Grantor Trust.

The Non-Grantor Trust, however, cannot attain age 59½, become disabled, or have a life expectancy, as contemplated by sections 72(q)(2)(A), (C), and (D), respectively. Thus, the exceptions provided by these provisions are not applicable to distributions under the Contract in the Non-Grantor Trust Scenario.

#### Section 72(q)(2)(B)

Section 72(q)(2)(B) provides an exception to the 10% additional tax if a distribution is made on or after the death of the “holder” or, when the “holder” is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)). Section 72(s)(6)(B) defines the primary annuitant as the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust is the “holder” of the Contract because it is designated in the Contract as the owner of the Contract. The Non-Grantor Trust is not an individual, however, so the exception provided in section 72(q)(2)(B) applies if the distribution is made on or after the death of the primary annuitant, as defined in section 72(s)(6)(B). In the Non-Grantor Trust Scenario, the primary annuitant is the Non-Grantor Trust Beneficiary. Thus, the exception provided in section 72(q)(2)(B) will apply in the Non-Grantor Trust Scenario to distributions made on or after the death of the Non-Grantor Trust Beneficiary.

#### Section 72(u)(1)

As discussed above, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust is the “holder” of the Contract because it is designated in the Contract as the owner of the Contract.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust Beneficiary is the only beneficiary of the trust and the only person who will benefit from the distributions under the Contract. Thus, the Non-Grantor Trust is holding the Contract for the benefit of the Non-Grantor Trust Beneficiary, a natural person. Accordingly, the holding of the Contract by the Non-Grantor Trust is not taken into account for purposes of section 72(u)(1).

This determination is consistent with the purpose for adopting section 72(u), which was discussed above. Because the Contract in the Non-Grantor Trust Scenario is not issued in the employment context, the arrangement does not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

## **RULINGS**

We rule that in the Grantor Trust Scenario –

(1) For purposes of section 72(q)(2), (i) the Grantor is the “taxpayer,” so the exceptions in sections 72(q)(2)(A), (C), and (D) will apply based on the age, disability, and life or life expectancy, respectively, of the Grantor and (ii) the Grantor Trust is the “holder” of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the individual Grantor Trust Beneficiary.

(2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Grantor Trust for the Grantor, so that section 72(u)(1) will not apply even though one of the Grantor Trust Beneficiaries is a charitable organization.

We rule that in the Non-Grantor Trust Scenario –

(1) For purposes of section 72(q)(2), (i) the Non-Grantor Trust is the “taxpayer,” so that the exceptions in sections 72(q)(2)(A), (C), and (D) will not apply to any distribution from the Contract because the Non-Grantor Trust cannot attain age 59½, become disabled, or have a life or life expectancy within the meaning of such sections and (ii) the Non-Grantor Trust is the “holder” of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the Non-Grantor Trust Beneficiary.

(2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Non-Grantor Trust for the Non-Grantor Trust Beneficiary, so that section 72(u)(1) will not apply.

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter, including whether the Contracts qualify as annuity contracts for purposes of section 72.

The ruling contained in this letter is based upon information and representations submitted by the 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 who requested it. A copy of this ruling must be attached to any tax return to which it is relevant. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Daniel P. Phillips  
Senior Counsel, Branch 4  
Financial Institutions & Products

cc: