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Trusts as Owners of Annuity Contracts

In this issue of *Legal & Tax Trends* we examine the tax and planning issues presented when a trust is the owner of an annuity contract. At the heart of the discussion is the so called non-natural person rule of IRC section 72(u) which denies tax deferred treatment to annuity contracts that are owned by a non-natural person such as a trust or corporation. This issue will explore the exceptions to the rule, as interpreted by the Internal Revenue Service in rulings, and discuss some potential planning opportunities. But be aware that the lack of guidance from the Service continues to make this a difficult area to navigate.

I. INTRODUCTION

The income taxation of annuity contracts is governed by Internal Revenue Code section 72. This code provision underwent extensive revision as a result of the tax simplification and reform measures of the 1980s. The legislation was intended to discourage the use of annuity contracts as short-term investments rather than as long-term retirement savings vehicles. To this end, the legislation fundamentally altered the manner in which amounts withdrawn from annuities are taxed, and imposed penalties on income withdrawn prior to the contract holder's attaining age 59 ½. In addition, Congress added a new Code provision, section 72(u), which denies tax-deferred treatment to any annuity that is not held by a natural person.

Section 72(u) was designed to discourage the practice, then in use by corporations, of purchasing annuity contracts to informally fund non-qualified deferred compensation arrangements. As stated in the legislative history to 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.”¹

Congress was concerned that the disincentive to provide qualified pension plan benefits undermined the non-discrimination rules of qualified plans by encouraging employers to establish non-qualified plans which could only be offered to a limited class of employees.

II. THE NON-NATURAL PERSON RULE

Section 72(u)(1) provides that “If any annuity contract is held by a person who is not a natural person (A) such contract shall not be treated as an annuity contract for purposes of [the Internal Revenue Code] . . . (other than subchapter L) and (B) the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account.”

The language of section 72(u)(1) is quite straightforward—an annuity contract will not be treated as an annuity contract, and will therefore not provide tax deferral, if it is owned by a non-natural person. If, however, the non-natural person is merely holding the contract as an agent for a natural person, this rule will not apply and deferral will be available. The critical question then, is under what circumstances

¹ S. Rep. No. 99-313, at 567 (1986).

such an agency arrangement will be deemed to exist. Unfortunately, neither the Code nor the regulations provide any explanation, although the legislative history provides the following example:

“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.”²

The Service did issue a ruling in which it determined that a trust created by an employer for the benefit of the employees was acting as an agent for natural person(s) when it purchased a group annuity contract and each employee received a certificate.³ The employees were presently taxed on employer contributions and while the plan was subject to ERISA it was not intended to be a qualified plan. The same employer was making some changes to the group annuity contract and requested a new ruling that the contract qualified as an annuity under §72. Another favorable ruling was issued by the Service in which it stated that the group annuity contract continues to qualify under §72.⁴

In addition to the exception for contracts held by an entity as an agent for a natural person, there are five specific exceptions to the non-natural person rule set out in section 72(u)(3). The exceptions are applicable to any annuity contract that:

1. is acquired by the estate of a decedent by reason of the death of the decedent;
2. is held under a qualified retirement plan, a 403(a) plan, a 403(b) program, or an individual retirement plan;
3. is a qualified funding asset (as defined in section 130(d));
4. is purchased by an employer upon termination of a qualified retirement or 403(a) plan and held until all amounts are distributed to the employee for whom the contract was purchased, or to the employee's beneficiary; or
5. is an immediate annuity.

Section 72(u) does not prohibit ownership of annuity contracts by corporations and other entities, it simply denies such entities the benefit of tax deferral. The

² H.R. Rep. No. 99-426, at 703 (1986).

³ See PLR 200018046.

⁴ See PLR 200720004.

changes to section 72(u) were effective with respect to contributions to annuity contracts after February 28, 1986. Thus, pre-March 1, 1986 annuity contracts to which no later contributions were made are, in effect, grandfathered. If contributions are made to a pre-March 1, 1986 contract, section 72(u) would apply to the later contributions, although the application of the rule to such contracts is uncertain. For this reason, most tax advisors cautioned against making a post February 28, 1986 contribution to a pre March 1, 1986 contract.

The legislative history suggests that unless a contract meets one of the above exceptions, there is no other circumstance under which a corporation can be deemed to be acting as an agent for a natural person. The same would appear to be true of ownership by a partnership,⁵ LLC or S corporation, despite the fact that these are all “flow-through” entities for income tax purposes.

In contrast, it is far more likely that a trust could be deemed to be the nominal owner of an annuity contract given the nature of the relationship between trust beneficiaries and the property held in trust, i.e., the beneficiaries are the beneficial owners of the property held in trust, the trustee merely holds legal title. In many instances, this relationship would support an argument that a trustee’s ownership is nominal and that the contract should consequently be treated as held by a natural person.

In a series of private letter rulings dating from 1989, the Internal Revenue Service has been called upon to rule whether a trustee’s ownership of an annuity contract was nominal or not. These rulings were presumably requested because purchasing an annuity contract within an irrevocable trust can be beneficial, as it would allow the deferral of income that would otherwise be subject to the compressed tax brackets applicable to trust income. In 2010, for example, trust income in excess of \$11,200 is subject to the maximum federal income tax rate of 35%.⁶ In a trust not designed to provide current income to the beneficiaries, the ability to invest in an annuity contract and allow earnings to accumulate on a tax-deferred basis could be quite advantageous. Unfortunately, the fact that IRS guidance has come only in the form of private letter rulings means there is no authority upon which taxpayers can rely. The early rulings suggested that for a trust-owned annuity to be deemed to be held by a natural person, there could only be one trust beneficiary. The most recent ruling indicates that a multiple beneficiary trust can likewise qualify. A review of the rulings offers an insight into the Service’s view of the breadth of the exception.

Ownership by a Grantor Trust

The grantor trust rules of IRC sections 671 through 678 cause the grantor of a trust to be treated as the owner of trust assets for income tax purposes and

⁵ See Internal Legal memorandum 199944020 in which the Service determined that the partnership was not acting as an agent for a natural person when the annuity in question was an asset of the partnership.

⁶ See Revenue Procedure 2009-50, 2009-45 IRB 1 (15 October 2009).

require trust income to be reported on the grantor's income tax return. If a grantor trust were to own an annuity contract, the grantor would be treated as owning the contract for income tax purposes, and it would seem to follow that the grantor would be treated as the owner for purposes of the non-natural person rule. This would seem particularly true if the grantor trust was a revocable living trust, since the grantor would have a retained power to terminate the trust and reacquire title to all assets. But if the grantor trust is an irrevocable trust, application of the rule is less clear because although the grantor would be treated as the owner for income tax purposes, he or she would normally not have any retained right to income or principal and would have no beneficial interest in any trust asset, including the annuity contract. Under these circumstances, it is not clear that the trust's status as a grantor trust, in and of itself, is sufficient to cause the annuity contract to be deemed to be held by a natural person. It may, instead, be necessary to look to the trust beneficiaries for this purpose.

Of the rulings that have been issued relating to trust-owned annuity contracts, three have involved grantor trusts. In two of these⁷, the trusts were so-called "secular" trusts created by employees for the purpose of receiving and investing bonuses paid by the employer. The employees could elect to have the bonused amounts paid directly to them or to the trustee, and, in one of the cases, the employee was able to direct the investment of trust funds. In both instances it was intended that the trustees would invest in annuity contracts. In neither ruling did the employer have any interest in the trusts—the employees alone were entitled to all the benefits.

The Service noted in each case that the employee would be considered the owner of the trust because he or she would receive the economic benefit of the amounts paid by the employer to the employee's trust. Moreover, since the entire income of the trust would be distributed to the employee, or accumulated for future distribution to him or her, the employee would be treated as the owner of the trust under section 677 of the Code. Consequently, the Service concluded that an annuity contract held by the trust would be deemed held by a natural person.

The third ruling involved a trust created to pre-fund funeral expenses.⁸ Under the arrangement, the grantor would make an irrevocable contribution to a trust of which he would be the beneficiary, and the trustee would invest the trust funds in an annuity contract or contracts. Upon the death of the grantor, the proceeds of the contract would be distributed to provide a casket and burial services for the grantor. Since state law imposed an obligation on the estate to pay for the grantor's funeral, the Service determined that the payment of the grantor's burial expenses pursuant to the terms of the arrangement constituted a reversionary interest in the trust property. Consequently, the grantor would be treated as the owner of both the corpus and income of the trust, and the annuity contract or

⁷ Priv. Ltr. Rul. 9316018; Priv. Ltr. Rul. 9322011.

⁸ Priv. Ltr. Rul. 9120024

contracts held by the trust would be deemed to be held by a natural person for purposes of section 72(u).

In all three of these rulings, the grantor of the trust held a beneficial interest in the trust. In the first two, the grantor was to receive all of the trust income and corpus, and in the third ruling, the grantor's estate would receive the benefit. Although the result in these rulings appears correct, it is necessary to ask whether the result would have been the same if the grantors had held no beneficial interest in the trusts.

Ownership by a Trust with One Beneficiary

Another pair of early rulings involved the acquisition of an annuity contract by the trustee of a trust created for the benefit of one individual, apparently a child of the grantors.⁹ Under the terms of the trust, the trustee had discretion to pay income and corpus to the beneficiary until age 40, at which point the entire trust corpus was to be distributed to the beneficiary. (The ruling was silent with respect to the disposition of trust corpus in the event the beneficiary died before attaining age 40.) The Service reviewed the legislative history of section 72(u) and simply concluded that although the trustee was the owner of the annuity contract, the trustee's ownership was nominal compared to that of the beneficiary and consequently, the beneficiary was the beneficial owner of the annuity contract.

Because the ruling failed to describe how the trust assets would be distributed in the event the beneficiary died before attaining age 40, it is not known whether any other person held an interest in the trust, as a contingent remainderman, and what bearing this may have had on the holding. For example, if the trust provided that the corpus would be paid to the beneficiary's estate, or if it were subject to a testamentary general power of appointment exercisable by the beneficiary, the ruling could be viewed as standing for the proposition that a trust's ownership of an annuity contract will be deemed nominal as long as all interests in the trust are held by one beneficiary. On the other hand, if the trust provided that corpus would pass to another person upon the death of the beneficiary, the ruling may mean that two persons can have an interest in a trust, and the trust's ownership of an annuity will still be deemed nominal. But must that interest be a contingent remainder interest, or can it be a vested remainder interest? Stated differently, would the holding have been the same if the beneficiary had held only a life income interest, and no right to receive principal?

In a series of rulings with almost identical facts,¹⁰ the Service determined that a trust was acting as an agent for a natural person when it purchased an annuity contract for the sole benefit of the settlor's grandchild. The terms of the trust provided for the distribution of a portion of the trust when the beneficiary attained ages 30, 35 and 40. If the beneficiary failed to request a distribution upon the

⁹ Priv. Ltr. Rul. 9204010 and 9204014

¹⁰ Priv. Ltr. Ruls. 200449011, 200449013, 200449014, 200440015, 200449016 and 200449017

attainment of an age for which a distribution is permitted, then the trustee is directed to distribute that amount to a separate trust for the sole benefit of the beneficiary. All distributions to either the beneficiary or the separate trust will be in the form of an annuity contract. In addition, if the beneficiary dies before attaining the age at which the trust is set to terminate, the annuity contract will be paid to the beneficiary's issue or if there is no issue then to or for the benefit of those related to the beneficiary.

This ruling did not address what the tax consequences would be under §72 if any distribution from the trust was in the form of cash. An in depth discussion of the tax issues pertaining to a distribution from a trust owned annuity can be found below in the section of the article entitled "Application of the Penalty for Premature Distributions."

Ownership by a Charitable Remainder Trust

The Service has issued only one ruling in which it determined that an annuity contract held in trust was not held as an agent for a natural person. In that ruling, the trust in question was a charitable remainder trust, under which the remainder interest was held by a charitable organization, and the unitrust interest was held by two grantors, who were natural persons.¹¹ The ruling cited the language of section 72(u) and with no discussion simply stated that the trust would be required to include in its ordinary income the income on the annuity contract because the trust ". . . will not hold the annuity contract as 'an agent for a natural person' within the meaning of section 72(u)(1)."

Given the absence of any discussion, it is impossible to determine the basis for the Service's conclusion and the relative weight to be afforded the fact that (1) there were two beneficiaries of the unitrust rather than one, and (2) the remainder interest was to pass to a non-natural person. With respect to the former, the relevant question, as noted above, is whether the language of section 72(u), relative to ownership as an agent for "a" natural person, is to be read literally, such that a trust with more than one beneficiary would not qualify. With respect to the latter, although natural persons held the unitrust interest, was the fact that the remainder interest was held by a non-natural person the controlling factor? And, as also noted, if that remainder interest had been contingent, rather than vested, would the result have been different? Although not conclusive, a 1997 ruling sheds some additional light on these questions.

Ownership by a Trust with Multiple Beneficiaries

In September of 1997, the Service issued a private letter ruling, which involved the acquisition of an annuity contract by a testamentary trust.¹² The trust was to be divided into separate shares for each remainderman, but the income from all

¹¹ Priv. Ltr. Rul. 9009047

¹² Priv. Ltr. Rul. 9752035.

shares was to be paid to the life income beneficiary. The trustees were given the power to distribute corpus to or for the benefit of the life beneficiary, the remaindermen, or the heirs of the remaindermen, under an ascertainable standard. The trustee intended to invest in an annuity contract which was to remain in deferred status until a future date specified in the contract, at which point a number of settlement options would be available. The life beneficiary was the annuitant.

The Service cited the language of section 72(u) and its legislative history and, as it had done in prior rulings, with no discussion, stated that although the trust was the owner of the contract, “. . . its ownership interest is nominal compared to Life Beneficiary and Remaindermen.” Accordingly, the Service ruled that the contract was held by a natural person for purposes of section 72(u)(1) of the Code.

Although the outcome of the ruling was favorable, the absence of any discussion leaves many unanswered questions. It is uncertain, for example, if the ruling should be read to mean that as long as all interests in a trust are held by natural persons, any annuity contract owned by a trust will be deemed to be held by a natural person. Assuming this is too broad a reading, then under what circumstances will a trust’s ownership be considered more than “nominal”? Will a trust’s ownership be deemed nominal if the trustee has complete discretion with respect to making or withholding of distributions of income and principal to the beneficiaries? Must all beneficiaries be identified, and must their interests be vested?

The Service issued another ruling¹³ in which a trustee was directed to make a nominal distribution to one beneficiary and given discretion to distribute income to another beneficiary. The trust was primarily for the benefit of the three remaindermen and trustee stated that the three individuals were natural persons as the term was used in section 72(u). The trustee proposed purchasing three annuity contracts in which each remainderman was named as the annuitant of one of the contracts. At the termination of the trust, the annuity contracts will be distributed to the named annuitants and the trustee further stated that at no time would the trust distribute the contracts to anyone other than the three remainderman. Based upon the facts presented in the ruling request the Service determined that the annuity contracts are considered owned by natural persons for purposes of §72(u)(1). In addition, the IRS provided that the distribution of the annuity contracts to the remaindermen would not be considered a gratuitous transfer under section 72(e)(4)(C).

¹³ Private Letter Ruling 199905015.

III. IMPACT ON OTHER PROVISIONS OF SECTION 72

Keeping in mind that private letter rulings carry no precedential weight, the rulings described above suggest that an annuity contract acquired within most inter vivos or testamentary irrevocable trusts can provide tax deferral. It is, however, important to consider the impact that other provisions of section 72 would have on such arrangements.

Distributions Upon the Death of the Holder of an Annuity Contract

Section 72(s) sets forth the required distribution rules, which an annuity contract must satisfy upon the death of the holder of an annuity contract. Specifically, it provides that if the holder of the contract dies after the annuity starting date and before the entire interest has been distributed, the remaining interest will continue to be distributed at least as rapidly as the method of distribution being used at the time of death. In addition, if the holder of the contract dies before the annuity starting date, the entire interest must be distributed within five years of the date of death. An exception to this general rule allows a designated beneficiary to elect, within one year of death, to take distribution of the proceeds over his or her life expectancy, or over a period not to exceed life expectancy. (A designated beneficiary is any individual designated as a beneficiary by the holder of the contract.) Moreover, if the holder's surviving spouse is the designated beneficiary, the surviving spouse has the ability to continue the decedent's contract as though it were his or her own.

If an annuity contract is owned by a non-natural person and an exception to section 72(u) does not apply, the contract will not be treated as an annuity contract, and the required distribution rules of section 72(s) would not apply. If the contract is treated as held by a natural person, however, the rules will apply, but their application to distributions upon the death of the holder before the annuity starting date is complicated by the fact that the "holder," that is, the trustee, cannot be said to die. Section 72(s)(6) provides, however, that where the holder of an annuity contract is a corporation or other non-individual, the "primary annuitant" shall be treated as the holder for purposes of applying the distribution rules. The term "primary annuitant" is defined as the individual whose life is of primary importance in determining the timing or amount of the payout under the contract.

It is worth noting that section 72(s) was enacted prior to section 72(u). This explains why 72(s)(6) makes reference to annuity contracts of which a corporation is the holder, despite the clear intent underlying section 72(u), that no contract held by a corporation be treated as an annuity contract. (Section 72(s)(6) does continue to apply, however, to any contract issued to a corporation prior to March 1, 1986.)

If a trust owns a deferred annuity contract, it is the death of the annuitant that triggers a distribution pursuant to section 72(s)(6). Since the trust would (normally) be the beneficiary of the contract, the distribution would be made in accordance with the general rule that all amounts must be distributed within five years of death. Since a designated beneficiary must be an individual, the exception to the five-year rule that allows distribution to be made over the life expectancy of a designated beneficiary would appear inapplicable. In contrast, the final regulations under section 401(a)(9), which govern distributions from qualified plans and IRAs, provide that so long as certain requirements are met, it may be possible to look through the trust and take distributions based upon the life expectancy of the oldest trust beneficiary. A similar exception for amounts received from a non-qualified annuity contract has never been specifically authorized.

If a trust is a grantor trust, and the grantor and the primary annuitant are not the same person, the relevant question is whether the grantor, rather than the primary annuitant, should be treated as the holder for purposes of applying the distribution rules of section 72(s). If the grantor were treated as the holder, then it would be the grantor's death, rather than that of the primary annuitant, that would determine when distribution from the contract would be made.

Application of the Penalty for Premature Distributions

IRC Section 72(q)(1) imposes a 10 percent penalty tax on premature distributions from annuity contracts. The penalty is imposed on “. . . any taxpayer [who] receives any amount under an annuity contract . . .” and is levied on the portion of the amount received that is includible in the taxpayer's gross income. Section 72(q)(2) provides that the penalty shall not apply to certain distributions, including any distribution “. . . made on or after the date on which the taxpayer attains age 59 ½, [or] . . . made on or after the death of the holder (or where the holder is not an individual, the death of the primary annuitant . . .” (emphasis added).

If an annuity contract is owned by a trust as an agent for a natural person, it is not clear how the 10 percent penalty is to be applied to amounts received under the contract because of the difficulty of identifying the “taxpayer” for purposes of section 72(q)(2). For example, until a contract is annuitized, only the owner, or holder, is entitled to receive any amount under the contract. This would suggest that the holder is the “taxpayer” whose age is relevant for purposes of applying the penalty to amounts received prior to age 59 ½. If this were correct, all withdrawals from a trust-owned contract would be subject to the penalty since a trust has no age. On the other hand, if a contract is annuitized, and under the terms of the contract the annuitant is entitled to receive all distributions, it might be argued that the annuitant is the “taxpayer” referred to in the exception and that his or her age is determinative. In such a case, however, the terms of the contract would appear controlling, because if the annuitant is merely the measuring life, and the trustee, as owner of the contract, has the power to direct

the annuity payments to any payee of his or her choosing, the annuitant's age may be irrelevant.

Since the primary annuitant is treated as the holder of a trust-owned annuity contract for purposes of requiring a distribution upon the death of the "holder", it might be argued that it is also appropriate to look to the primary annuitant for purposes of applying the age 59 ½ exception to the premature distribution penalty. Doing so would assure consistent treatment of amounts received under the contract during life and at death and would arguably provide no greater tax benefit than if the contract had been owned by the annuitant. It would, however, allow the penalty to be circumvented by a trust with multiple beneficiaries, if at least one beneficiary were age 59 ½. If that beneficiary were named as the annuitant, the trustee would be able to withdraw unlimited amounts from the contract, free of penalty, despite the fact that the withdrawn amounts might then be distributed to beneficiaries under age 59 ½. It is questionable whether Congress would have intended such a result.

Assuming the annuitant's age is not the relevant measure, is it instead the age of the beneficiary or beneficiaries? If so, must all beneficiaries be over age 59 ½ for the penalty to be avoided? Moreover, if the trust is a grantor trust, is the penalty then based on the age of the grantor rather than the annuitant or the beneficiary or beneficiaries? Unfortunately, each of these questions remains unanswered. To avoid these issues, consideration should be given to having the trustee distribute the annuity contract outright to the beneficiary before the time at which withdrawals are to begin.

IV. PLANNING WITH TRUST-OWNED ANNUITIES

As previously noted, for income and estate planning purposes it is sometimes desirable for a trust to be the owner of an annuity contract. In such situations, the application of section 72(u) and other relevant subsections of section 72 will naturally determine the appropriateness of this strategy. The following discusses some common situations in which an annuity contract might be purchased or acquired by a trustee and explores the implications of doing so.

Ownership by a Minor's Trust

A parent or grandparent interested in making gifts to children or grandchildren will sometimes create a section 2503(c), or minor's trust, in order to receive and hold the transferred funds. Gifts to a 2503(c) trust will qualify for the annual gift tax exclusion despite the fact that the beneficiary has no present right to receive trust income or principal. However, upon the minor's attainment of age 21, he or she must be given the right for a limited period of time to demand distribution of the entire trust principal. In the event the beneficiary declines to exercise this right, the trust property can continue to be held in trust for the benefit of the beneficiary.

Based on the rulings discussed previously, it is most likely that such a trust would be deemed to hold an annuity contract as an agent for a natural person for purposes of section 72(u). As a result, the purchase of the annuity contract would enable the income accruing within the contract to be deferred and would not be subject to the compressed income tax brackets applicable to trusts. As noted above, it is likely that the 10 percent penalty for premature distributions would apply to all amounts distributed unless the contract is annuitized. This factor must be carefully considered before the purchase is made. Assuming the annuity is intended for the long-term income needs of the beneficiary, rather than an intermediate-term need such as education funding, the purchase may be appropriate.

Ownership of an Annuity by a Charitable Remainder Trust

As previously noted, ownership of an annuity contract by a charitable remainder trust was the subject of a private letter ruling issued in 1989. The outcome of the ruling was favorable in that the Service ruled that the trust would qualify as a charitable remainder trust. (The fact that the annuity contract was deemed not held by a natural person, and therefore did not provide tax deferral, had no adverse impact because a charitable remainder trust is a tax-exempt entity and pays no income tax.) However, several years later, the Service began to express concern about the purchase of annuity contracts within charitable remainder unitrusts, specifically, within “net-income” and “net-income-with-make-up” charitable remainder trusts (NIMCRUTs). The Service was concerned about the trustee’s ability to manipulate the income of the trust, and correspondingly, the income of the beneficiaries, through withdrawals from the annuity contract. In 1997, the Service announced that it would not issue advance rulings or determination letters with respect to the qualification of a trust as a charitable remainder trust if the unitrust amount is calculated under the net-income or net-income-with-make-up method and a grantor, trustee, beneficiary or person related or subordinate to the grantor, trustee or beneficiary can control the timing of the trust’s receipt of income from a partnership or deferred annuity contract.

The Service’s attention had been drawn to the increased use of charitable remainder trusts as a source of supplemental retirement income, primarily by individuals whose retirement plan contributions were limited by the qualified plan rules. A net-income-with-make-up charitable remainder unitrust became a vehicle of choice because of its unique characteristics. Unlike a charitable remainder annuity trust, which must distribute the required payout each year regardless of the amount of trust income received, a net-income charitable remainder unitrust need only distribute the income actually earned. Moreover, the make-up provision would allow any shortfall to be made up in the future when the trust income exceeded the required payout amount.

A NIMCRUT can operate as a quasi-retirement plan if the trust assets are invested in a manner that will minimize income and emphasize growth during the grantor/beneficiary's working years and are then repositioned upon retirement to emphasize income. An annuity contract would appear to be an ideal asset to use for this purpose given the fact that as long as no distributions are taken from the contract, there would appear to be no income, and hence no required payout. Upon the beneficiary's retirement, the trustee could begin taking withdrawals from the contract, which would provide the trustee with income to be distributed to the beneficiary.

It is important to recognize that the "income" of a NIMCRUT is not income for tax purposes, but may be considered income for fiduciary accounting purposes. Whether a particular item is considered income or principal for these purposes depends on local law and on the provisions of the governing instrument. If the trust provisions are fundamentally different from local law, local law will control. This means that in some jurisdictions the income accruing within a trust-owned annuity contract could be treated as fiduciary income, which would require the trustee to make distributions of the income, up to the amount of the required payout. It appears, however, at least in those states that have adopted the Revised Uniform Income and Principal Act, that the trust will not be deemed to have any fiduciary income until the trustee actually withdraws funds from the annuity contract.

Despite its pronouncement that it would not rule on a NIMCRUT holding an annuity contract, early in 1998 the Service issued just such a technical advice memorandum.¹⁴ The TAM addressed three questions: (1) whether the purchase of annuity contracts by the trustee was an act of self-dealing (since the annuitants were disqualified persons); (2) whether the purchase would jeopardize the trust's qualification as a charitable remainder unitrust; and (3) whether the trustee's right to withdraw from or surrender the annuity contracts would cause the trust to have "income" for unitrust purposes? The Service responded to all three questions in the negative, noting with respect to the third question that although the relevant state statute appeared ambiguous, the statute implied that a trust does not realize either income or principal until it actually receives possession of money or other property. More recently, in informal discussions, the IRS has indicated that despite the ruling, the area remains under study.

Although the purchase of an annuity within a NIMCRUT remains uncertain, it appears to have some promise in light of these recent developments. It must be kept in mind, however, that the strategy is not without its risks. The payout from a unitrust is based on the value of the trust as valued annually. If the trust assets decline in value, the required payout will decline as well. With a NIMCRUT, the payout is further limited by the amount of income actually generated. Thus, the character of the distribution from the annuity contract as trust income or corpus again becomes an issue in determining whether distributions attributable to

¹⁴ Tech. Adv. Mem. 9825001.

capital gains earned within the contract can be distributed to the beneficiary. If any part of a distribution is deemed to consist of capital gains, that part can only be paid to the beneficiary if local law or the trust instrument defines capital gains as fiduciary income.

Credit Shelter Trust as Beneficiary of an Annuity Contract

The foregoing discussion has focused exclusively on a trust as the owner of an annuity contract. There is, however, a common circumstance in which a trust is considered a potential beneficiary of an annuity contract. The following briefly discusses the considerations involved in naming a credit shelter trust as the beneficiary of an annuity contract.

A credit shelter trust is commonly incorporated into an estate plan in order to make use of the testator's unified credit upon death.¹⁵ The trust is typically designed to provide income to the surviving spouse for life and to pass to the children upon the spouse's death. In some instances, the testator may hold a substantial investment in annuity contracts and want to designate the credit shelter trust as the beneficiary in order to make full use of his or her unified credit. Doing so could have adverse tax implications.

From a planning perspective, an annuity contract is not an ideal asset to be used to fund a credit shelter trust for the simple reason that the contract will not obtain an increase in cost basis upon the death of the contract owner.¹⁶ As a consequence, the built-in income tax liability dilutes the benefit of the unified credit inasmuch as the decedent's heirs will not receive the portion attributable to the income tax. But, in addition to the general disadvantage of naming a credit shelter trust as the beneficiary, there are other factors, which must be considered.

As noted above, when a trust is named as the beneficiary of an annuity contract, it appears that the only distribution option available to the trustee is to receive the entire interest within five years of the death of the primary annuitant. In contrast, an individual beneficiary is able to take distribution over his or her life expectancy (or over any period not in excess of life expectancy) and thereby gain maximum

¹⁵Due to uncertainties regarding the federal estate and GST tax in 2010, clients must speak with their qualified legal and tax counsel to confirm the current status of the law, to discuss their current estate plan and to discuss what planning options (including drafting provisions) are available during the upcoming year.

¹⁶As of the date this material was created, the step-up basis rules have been replaced by carry-over basis rules with two exceptions. The decedent's executor may allocate a basis increase of up to \$1.3 million but not above fair market value (FMV) for certain property passing to nonspouse beneficiaries. Basis of certain property passing to a spouse may receive an additional increase of up to \$3 million (but not above FMV). Assets that are items of *income in respect of a decedent* (IRD) can not receive an allocation of basis by the decedent's executor.

benefit from the tax deferral provided by the contract. Moreover, if the beneficiary is the spouse of the decedent, the contract can be continued in its deferred status. The trustee will have to take distribution no later than five years after death so that the entire deferred gain will be subject to income tax by the end of the five-year period. If the distributions were retained within the trust, the trustee would be responsible for the income tax rather than the beneficiaries. If they are paid out to the trust beneficiaries, a lower overall income tax may be payable on the distributions, but this may frustrate the objective of using the trust as an accumulation vehicle, or be inappropriate given the ages or situations of the beneficiaries. Therefore, it will be important to carefully weigh the estate tax benefits of funding the credit shelter trust with the annuity proceeds and thereby fully utilizing the unified credit at the first death against the income tax disadvantages of naming the trust as beneficiary.

V. CONCLUSION

Annuity contracts present special problems and raise special considerations when the owner or beneficiary is not a natural person. Although the law is intended to prevent corporations and other entities from enjoying the benefits of tax deferral, ownership of an annuity by a trust appears to permit tax-deferral in many situations. Yet, the only guidance that has been provided with respect to section 72(u) and the non-natural person rule has been through private letter rulings. What these rulings suggest is that ownership by a trust will generally provide tax-deferral, at least if all of the beneficiaries are natural persons. However, until there is a more authoritative pronouncement issued by the Service, trust ownership of an annuity contract should be approached with appropriate caution.

Legal & Tax Trends is provided to you by a coordinated effort among the MetLife advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, Lillie Nkenchor and Barry Rabinovich. All comments or suggestions should be directed to tbarrett@metlife.com or jdonlon@metlife.com, Co-Editors.

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