

DON'T HOLD ANNUITIES IN TRUSTS - WELL, MAYBE IT'S OKAY

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Section 72 of the Internal Revenue Code generally provides favorable deferral of income tax for qualified annuities. However, Code Section 72(u) disallows such favorable treatment when the annuity is owned by someone other than a natural person, such as a trust. An exception to the exception allows a trust to hold the annuity as an agent for a natural person.

A recent private letter ruling has employed the "agent for a natural person" exception to allow use of the trusts. The subject ruling allowed the trust to purchase annuities with the remaindermen as the annuitants. Another individual was the current beneficiary of the trust. To the extent that distributions were made from the annuity prior to the death of the current beneficiary, those proceeds would be payable to the trust. After the death of the current beneficiary, the annuity policies will be distributed to the remaindermen (each receiving his or her annuity for which he or she is the annuitant).

The IRS examined the history of the Code Section 72(u) limit on non-individual ownership. It found that provision was largely intended to restrict an employer's use of annuity contracts to fund significant amounts of deferred compensation for employees. In the context of the subject trust, no such employment aspects were involved. Since all of the beneficiaries of the trust were natural persons, the IRS ruled that the Code Section 72(u) limits did not apply.

The IRS also ruled favorably in regard to Code Section 72(e)(4)(C). That provision holds that an assignment of an annuity contract without full and adequate consideration will be taxable as a sale of the contract based on the cash surrender value of the contract at that time. The IRS ruled that the later distribution of the annuity contracts to the individual remaindermen would not be subject to this deemed sale provision. Again, the IRS ruled favorably based on its reading of the legislative history. According to the ruling, the purpose of the restriction on gratuitous transfers of annuity contracts related to inhibiting taxpayers from continuing tax deferral beyond a life of an individual

taxpayer. Since such deferrals were not involved in the subject transfers, the IRS ruled that Code Section 72(e)(4)(C) will not apply.

Clearly, these rulings are very favorable for the requesting taxpayers, and are not directly supported by language of the Internal Revenue Code. However, it is doubtful if anyone is going to be upset by this. Note that this is not the first time that the IRS has provided ruling similar to this.

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