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LEGAL ALERT

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IRS Rules that Annuity Payouts with Automatic Increases Are Not "Substantially Equal Periodic Payments"

In PLR 201120011 (Feb. 11, 2011), the Internal Revenue Service (Service) ruled that nonqualified annuity payouts that automatically increase by a fixed percentage are not within the "substantially equal periodic payment" (SEPP) exception to the IRC § 72(q) premature distribution 10% penalty tax. Although the ruling applies by its terms only to nonqualified annuities, its conclusions implicitly extend to the comparable exception under the § 72(t) premature distribution penalty for qualified retirement plans.

By way of background, Notice 89-25, Q&A-12 approved three methods for determining SEPPs under the § 72(t) qualified plan rule, including "payments that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9)." That guidance was reformulated and modified by Rev. Rul. 2002-62, which restated this "RMD method" in the terms applicable to non-annuitized accounts – i.e., annually dividing the account balance by the applicable factor from certain IRS life expectancy tables. This guidance was extended to the § 72(q) rule for nonqualified annuities in Notice 2004-15.

On the facts of the ruling, payouts from a nonqualified fixed annuity could increase by 1%, 2%, 3% or 4% annually, as irrevocably elected at the outset by the contract owner. (Payments that increase in this manner are rare in qualified plans but sometimes are available under annuity contracts.) Annuity payments with these irrevocable, automatic increases would satisfy the RMD rules for annuitized payments. The Service read the RMD method in Rev. Rul. 2002-62 narrowly, however, to adopt only the RMD "account balance" mechanics. Since the increases in these annuity payouts were automatic and not driven by increases in an account balance, the Service concluded they were not SEPPs. The Service also rejected the taxpayer's argument based on the § 72(t) legislative history that SEPPs may increase by cost-of-living adjustments (COLA), on the basis that the increases here were at a fixed rate chosen by the contract owner.

- The reasoning of PLR 201120011, limiting SEPPs to payments that are explicitly described in Rev. Rul. 2002-62, differs from that in earlier PLRs and contravenes the Service's published FAQ on SEPPs, which specifically states that the methods in Rev. Rul. 2002-62 are *not* the only acceptable methods of computing SEPPs.

- In fact, it cannot be the case that the only SEPPs are those literally described in Rev. Rul. 2002-62. Under the reasoning of PLR 201120011, level fixed annuity payments for life made by an insurance company are literally described in neither the RMD method (since annuity payments are not computed as a liquidating account balance) nor the fixed amortization or fixed annuitization methods of Rev. Rul. 2002-62 (since those methods explicitly require use of IRS life expectancy tables rather than an insurer's annuity purchase rates). But level fixed life annuity payments must qualify for the § 72(q) and § 72(t) exceptions; they are the classic example of a SEPP.

- This may be another instance where qualified plan guidance (Rev. Rul. 2002-62) contemplates the more common qualified plan "account" context and overlooks the less common "annuity" context, which almost invariably produces unsound results if applied in the annuity setting without considered appreciation of and accommodation for the differences in those contexts.

- As a tax policy matter, it is difficult to find much objectionable with the pattern of payments in PLR 201120011; they systemically distribute the owner's interest over life in periodic payments that automatically increase annually in a predetermined amount comparable to historic COLA rates or less (U.S. CPI has increased annually by an average of 3.37% since 1913) and that would qualify under the RMD rules. This hardly seems a case where the tax benefits afforded nonqualified annuities or, by extension, qualified retirement plans are being abused by payments commencing prior to age 59-1/2.

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