

## DISCUSSION

### A. Treatment of Variable Annuities Generally

An annuity is defined for U.S. federal income tax purposes generally as a contract that is considered to be an annuity contract in accordance with the customary practice of life insurance companies.<sup>2</sup> The annuity must provide for a series of scheduled payments to the annuitant at some point in the future. Under the terms of a PPVA, generally the series of scheduled payments must begin no later than when the annuitant reaches the age of 95 or 100, and the entire PPVA account value must be distributed by the annuitant's age 125 or 130. An annuity generally must be held by a natural person, including a trust or other entity as an agent for a natural person.<sup>3</sup> There are certain exceptions to this rule, including an annuity acquired by the estate of a decedent because of the death of the decedent.

#### 1. Treatment of Scheduled Payments on the Annuity

Section 72 of the Code applies to determine income taxation of scheduled, periodic payments from a PPVA after the annuity starting date.<sup>4</sup> Such payments are generally referred to in section 72 of the Code as "amounts received as an annuity."<sup>5</sup> Under these rules, the owner will generally not be taxed on the return of their investment in the PPVA but amounts in excess of the return of investment allocated to each payment are includible as ordinary income for U.S. federal income tax purposes.

For a variable annuity such as the PPVA, the return on investment is considered equal to the expected return on the contract.<sup>6</sup> Under Treasury Regulations, the owner's investment in the contract is apportioned to each payment period.<sup>7</sup> Generally, for a variable annuity such as the PPVA, the investment in the contract is divided by the anticipated number of payments to be made to determine what portion of each of the periodic payments should be treated as a return of investment not subject to taxation.<sup>8</sup> The amount of the periodic payment in excess of this allocated portion of the return on investment is included in gross income as

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<sup>2</sup> Treas. Reg. § 1.72-2(a)(1).

<sup>3</sup> I.R.C. § 72(u). If the holder does not meet this requirement, the income on the contract is treated as ordinary income received or accrued by the owner during the tax year. The income on the contract is generally measured by the excess of the net surrender value of the contract as of the close of the tax year plus all distributions paid over the sum of net premiums paid and amounts includible in gross income for prior years. *Id.*

<sup>4</sup> Subject to certain exceptions, the "annuity starting date" is defined generally as the first day of the first period for which an amount is received as an annuity. Treas. Reg. § 1.72-4(b)(1). The first day of the first period for which an amount is received as an annuity is the later of (i) the date upon which the obligations under the contract become fixed, or (ii) the first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semi-annually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment. *Id.*

<sup>5</sup> See Treas. Reg. §§ 1.72-1(b); 1.72-2(b)(2), (3) (indicating that, among other things, an "amount received as an annuity" (i) must be received on or after the annuity starting date, and (ii) must be payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date).

<sup>6</sup> Treas. Reg. § 1.72-4(d)(3)(i).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* Detailed rules apply to determine the investment in the contract, including adjustments for refund provisions. See Treas. Reg. §§ 1.72-6, , 1.72-7, 1.72-10.