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DATED:

U.S. Tax Treatment of Private Placement Variable Annuity

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The following memorandum addresses the general U.S. federal income tax treatment of a U.S. individual owning a private placement variable annuity ("PPVA") to be

issued by an insurance company (the "Insurance Company").

SUMMARY

Generally the owner or beneficiary of the PPVA will not have taxable income for

U.S. federal income tax purposes in respect of the PPVA until a payment is made to him or her.

Thus there is deferral of taxation on the growth in value of the investment portfolio underlying a

PPVA, in contrast to the tax treatment if the owner instead made a direct investment outside of a

PPVA. The income on the PPVA is treated as ordinary income when received.

The owner or

beneficiary is generally permitted to reduce this income by the amounts invested in the PPVA,

although the timing of such recovery depends on the type of distribution.

For scheduled annuity payments made after the annuity starting date, generally

referred to as "amounts received as an annuity," the owner's income is generally partially

reduced by an allocated basis amount. That is, the amount the owner is considered to have

invested in the PPVA is allocated among these scheduled annuity payments.

The amount of the

payment in excess of this allocated amount is treated as ordinary income.

If the owner or beneficiary fully surrenders the PPVA for payment at any time or

makes a partial withdrawal from the PPVA before the starting date of the annuity, the surrender

payment or partial withdrawal is taxed as ordinary income to the extent that it exceeds the

adjusted basis in the PPVA – initially the deposit into the contract. After all gains are

distributed, the adjusted basis is received income tax-free.

Upon death of the owner, the PPVA will be included in the estate of the owner for

federal estate tax purposes. Payments from the PPVA will result in taxable income to the estate

or beneficiary of the PPVA for federal income tax purposes. However, neither tax will generally apply if a tax-exempt charity or private foundation is made the beneficiary of the PPVA either under the PPVA itself or as a legatee under the owner's will. In such case, for estate tax purposes the estate will receive a deduction for the charitable contribution offsetting the

inclusion of the PPVA in the estate. To the extent paid to a tax-exempt entity, the investment income and gains within a PPVA will not be subject to income tax.

FACTS

For purposes of this opinion, you have represented the following facts are true

with respect to the PPVA:

Under the terms of a PPVA, an issuer of the PPVA will agree to make a series of

payments to an annuitant over time, beginning no later than when the annuitant reaches age 95 or

100. The PPVA will be issued by the Insurance Company to U.S. individual investors (or to

trusts for the benefit of U.S. individual investors). It is intended that the PPVA will meet the

requirements of section 72 of the Code.¹

The owner of the annuity contract may select a beneficiary of the PPVA. The beneficiary receives the account value of the annuity at the annuitant's death.

There will be no limits on the amount that may be contributed to the PPVA. There will be a fee charged monthly by the Insurance Company on the Net Asset Value.

The PPVA account value will be held in a separate account at the insurance company. The contract owner will then instruct the Insurance Company to allocate the value to

one or more insurance-dedicated funds that are available on the PPVA platform. The PPVA

account value will reflect the investment return and market value of the insurance-dedicated

funds to which the separate account values are allocated. Each underlying insurance-dedicated

fund ("IDF") will meet the diversification requirements under section 817 of the Code. Except

where otherwise permitted under Treasury Regulation section 1.817-5(f)(2)(i) in order to receive

look-through treatment, all the beneficial interests in the IDFs will be held by one or more

separate accounts of one or more insurance companies, and public access to interests in the IDFs

will be held exclusively through the purchase of a variable annuity or a variable life insurance

contract.

The PPVA owner will be given various IDF investment choices upon making a deposit into the PPVA account. The owner will be permitted to reallocate amounts among the

IDFs from time to time. The separate account of the PPVA contract does not need to be

diversified in accordance with 817(h) of the Code (i.e., all of the account value could be

allocated to a single IDF). However, each IDF available to a PPVA owner will conform with

section 817(h) of the Code.

An owner of the PPVA may take unscheduled withdrawals from the PPVA account at any time before the annuity start date. Distributions may be taken in annual installments or lump-sums. The PPVA will permit the holder to designate a tax-exempt charity or tax-exempt private foundation as a beneficiary of the PPVA upon death of the policy holder.

1 All "Code" or "section" references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

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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.² 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.³ 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.⁴ Such

payments are generally

referred to in section 72 of the Code as "amounts received as an annuity."⁵ 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.⁶ Under Treasury Regulations, the owner's

investment in the contract is apportioned to each payment period.⁷

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.⁸ The amount of the periodic payment in

excess of this allocated portion of the return on investment is included in gross income as

² Treas. Reg. § 1.72-2(a)(1).

³ 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.

4 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.

5 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).

6 Treas. Reg. § 1.72-4(d)(3)(i).

7 Id.

8 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.

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ordinary income.⁹ Once the amount of the owner's investment in the PPVA is fully recovered, subsequent payments are fully included as ordinary income without reduction.

a. Recovery of Invested Amounts upon Death

If the owner of a PPVA dies and the account value is below adjusted basis, the taxpayer is generally permitted to deduct in his or her final return an amount equal to the remaining unrecovered investment in the annuity as an ordinary loss.¹⁰ There is a special

carryback rule that permits the deduction to be carried back to prior tax years.¹¹ If the PPVA

account value is above adjusted basis, distributions in excess of the adjusted basis are taxed at

ordinary income rates and additional distributions are free of tax.¹²

2. Other Distributions Taken from the PPVA

With respect to other unscheduled payments not considered to be amounts received as an annuity, e.g., cash withdrawals or complete surrender of the PPVA, the extent to

which such amounts are included in the gross income of the holder of the PPVA will depend on

when the amounts are received, the nature of the distribution and whether the amounts may be

considered a return on investment in the contract.

For amounts received in full discharge of the obligation under the PPVA in complete surrender, redemption or maturity, the amount included as ordinary income is reduced

to the extent the payment is treated as in the nature of a refund of the consideration paid for the

PPVA, i.e., income is reduced by the amount of unrecovered investment in the PPVA.¹³

If the amount is received on the PPVA before the annuity starting date, the payment is included in gross income to the extent allocable to income from the PPVA and is not

included in gross income to the extent allocable to the investment in the PPVA.¹⁴ For this

purpose, an amount is treated as allocable to income with respect to the PPVA to the extent that

such amount, net of surrender charges (if applicable), is in excess of adjusted basis. Once the

investment gain element of the PPVA has been fully distributed, subsequent payment amounts

are treated as in the nature of a refund of the consideration paid for the PPVA and are thereby

exempt from income tax.

⁹ Treas. Reg. § 1.72-2(b)(3). If an amount received is less than the return on investment, the holder may elect in a

succeeding tax year in which payment is received to redetermine the amounts received to take into account the

amount that would have been excludible had it been received in the earlier year.

10 I.R.C. § 72(b)(3)(A).

11 I.R.C. § 72(b)(3)(C).

12 If there is are annuity payments to the owner of a PPVA before death, then these rules apply to the amount received at death, and the rules described in the previous paragraphs apply to pre-death payments to the owner of a PPVA.

13 I.R.C. § 72(e)(5)(E).

14 I.R.C. § 72(e)(2)(B).

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a. Deemed Payments Resulting from Gifts¹⁵

An owner who assigns or pledges a portion of the value of the PPVA will be treated as receiving an unscheduled, non-annuity distribution under the contract.¹⁶ If an owner of the PPVA transfers it without receiving full and adequate consideration, the owner will generally be treated as receiving the excess of the cash surrender value of the PPVA over the holder's investment in the PPVA as an unscheduled, non-annuity distribution.¹⁷ An exception applies for transfers between spouses or transfers incident to a divorce.

3. 10% Penalty for Early Withdrawal

If a distribution is made prior to the date that the owner of the PPVA reaches the age of 59 $\frac{1}{2}$, an additional 10% tax penalty will be imposed on the amount includible in gross income.¹⁸ Certain exceptions apply. For example, the penalty does not apply if the distribution is made on or after the death of the holder (or, if the holder is not an individual, the death of the primary annuitant). The penalty also does not apply to a payment upon the total and indefinite disability of the recipient. An exception also exists for distributions that are part of a series of substantially equal periodic payments made for the life of the taxpayer or the joint lives of the taxpayer and his beneficiary. In such cases, the 10% penalty also does not apply.

4. Required Distributions upon Death of Owner

If an owner of the PPVA dies before the annuity starting date, under section 72(s) of the Code the entire interest must be distributed within either (1) five years after the death of the owner, or (2) the life of the designated beneficiary or a period not extending beyond the life expectancy of such beneficiary, but only if the owner's interest is payable to or for the benefit of a designated beneficiary. An exception exists for a spouse that is the designated beneficiary. In such case, no distribution is required and the spouse is treated as the holder of the annuity contract.¹⁹ If the owner of the annuity dies on or after the annuity starting date and before the entire interest on the annuity has been distributed, the remaining amount due on the annuity must be distributed at least as rapidly as under the method of distributions being used as of the date of death.²⁰

5. Gain or Loss upon Sale of PPVA

Gain or loss is generally recognized if an owner of a PPVA sells or otherwise disposes of the annuity other than by electing a settlement option.²¹ An

exception exists for
certain exchanges of an annuity contract for another annuity contract
involving the same
annuitant through section 1035 of the Code.

15 Pledging an annuity as collateral for a loan could also have tax
consequences but such a pledge is not anticipated
for the PPVAs.

16 I.R.C. § 72(e)(4)(A).

17 I.R.C. § 72(e)(4)(C)(i).

18 I.R.C. § 72(q).

19 I.R.C. § 72(s)(3).

20 I.R.C. § 72(s)(1)(A).

21 I.R.C. § 1001(a).

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B. Federal Income and Estate Taxation upon Death of Holder

There are special rules regarding inclusion of income to an estate or beneficiary

upon death that has not been previously taxed. However, if the owner of the annuity has given

the right to an amount deferred under a PPVA to a tax-exempt charity or private foundation upon

the owner's death, generally the income should not be taxed to the estate.

If the charity or

foundation qualifies as a tax-exempt entity, such income would also not be taxable to the tax-exempt

entity.

1. Inclusions of Annuity Payments in Taxable Income of Beneficiary upon Death

The Code has special rules designed to ensure taxation of amounts not previously

included in taxable income by an individual prior to death. Under section 691 of the Code, upon

death of an individual, items of income that are not properly includible in respect of a tax period

in which the individual died or a prior period is included in gross income when received of (A)

the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate

from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right

to receive the amount if the right to receive the amount is not acquired by the decedent's estate

from the decedent; or (C) the person who acquires from the decedent the right to receive the

amount by bequest, devise, or inheritance, if the amount is received after a distribution by the

decedent's estate of the right.²² This taxable income is commonly referred to as income with

respect to decedent, or "IRD." Such IRD may also occur if the right to the income is disposed of

by an estate.²³

Under these rules, taxable income on a PPVA may therefore be included in the income of a beneficiary on an annuity, including the estate itself, as IRD

upon death of the

owner-annuitant. For example, if the owner-annuitant of a deferred annuity contract such as the

PPVA dies before the annuity starting date, and the beneficiary receives the account value under

the annuity contract, the amount received by the beneficiary in a lump sum in excess of the

owner-annuitant's investment in the contract is includible in the beneficiary's gross income as

IRD.²⁴

2. Estate May Avoid IRD if Tax-Exempt Charity is Beneficiary

However, IRD to the owner's estate after the owner's death with respect to

the
PPVA should be avoided if a charity or private foundation that is tax-exempt
under section
501(c) of the Code is a beneficiary of the PPVA. The IRD in such case is not
received by the
estate but by the charity or foundation.
22 I.R.C. § 691(a)(1).
23 I.R.C. § 691(a)(2). Specifically, if a right to receive such amount is
transferred by the estate of the decedent or a
person who received such right by reason of the death of the decedent or by
bequest, devise, or inheritance from the
decedent, the estate or such person, as the case may be, includes in gross
income in the tax period of the transfer the
fair market value of such right at the time of such transfer plus the amount
by which any consideration for the
transfer exceeds such fair market value. Id. For these purposes, the term
"transfer" includes sale, exchange, or other
disposition, or the satisfaction of an installment obligation at other than
face value, but does not include transmission
at death to the estate of the decedent or a transfer to a person pursuant to
the right of such person to receive such
amount by reason of the death of the decedent or by bequest, devise, or
inheritance from the decedent. Id.
24 I.R.C. § 691; Rev. Rul. 2005-30, 2005-1 C.B. 1015.

The IRS has issued unpublished rulings that support this outcome.²⁵ For example, the IRS issued a private letter ruling regarding an annuity on which payment had not yet been made that was transferred to a charity upon death of the owner of the annuity. The IRS ruled that only the charity would include income from the annuity.²⁶ A trust was the beneficiary of the deferred annuity and under the terms of the trust distributed the annuity to a tax-exempt charity upon death of the owner of the annuity. The IRS ruled that the assignment to the charity was not a transfer triggering IRD to the estate and that only the charity would include distributions on the annuity in gross income as IRD when the distributions are made.²⁷ A similar conclusion was reached by the IRS in a private letter ruling when the annuitant had not assigned a beneficiary to the deferred payment annuity and upon the death of the annuitant the estate was considered the beneficiary under state law. The estate assigned the annuity to tax-exempt charities in partial satisfaction of the charities' share of the residue of the estate. The IRS issued a private letter ruling stating that the assignment did not trigger IRD to the estate and that only the charities would include payments on the annuity in gross income as IRD.²⁸ Some additional support is also provided by private letter rulings issued by the IRS with respect to the transfer of IRAs to tax-exempt charities or foundations. Under these rulings, the transfer of a decedent's IRA by the estate to a tax-exempt charity or foundation resulting in no IRD to the estate or other beneficiaries.²⁹ A similar conclusion has also been reached with respect to the transfer to a charity or foundation of certain pension or retirement rights held by the estate of a decedent.³⁰

a. IRD May Be Triggered if Transfer Is Made as Part of Pecuniary Bequest
IRD may thus be avoided if a tax-exempt charity or foundation is made a beneficiary upon death under the terms of the PPVA. Alternatively, the estate of the owner may be the beneficiary and the owner's will may bequeath the PPVA to the tax-exempt charity or foundation.

If the latter strategy is chosen, however, the form in which the bequest is made may be important. A transfer in lieu of a pecuniary bequest should be avoided.

3. Inclusion of Annuity in Estate for Federal Estate Tax Purposes

²⁵ Private letter rulings are not binding precedent on the IRS or a court.

However, they indicate the views of the IRS and can be cited as substantial authority for penalty purposes.

26 Although the ruling did not explicitly state this, if the charity meets the requirements of a tax-exempt entity such income should not be taxable to the charity.

27 P.L.R. 200803002 (Jan. 18, 2008).

28 P.L.R. 200618023 (May 5, 2006).

29 See, e.g., P.L.R. 200826028 (June 27, 2008); P.L.R. 200633009 (Aug. 18, 2006); P.L.R. 20052004 (May 20, 2005) (401(k) account as well as IRA); P.L.R. 199939039 (Oct. 4, 1999); P.L.R. 9818009 (May 1, 1998) (qualified retirement plan as well as IRA); P.L.R. 9723038 (June 6, 1997); P.L.R. 9341008 (July 14, 1993).

30 See, e.g. P.L.R. 2008450209 (Nov. 7, 2008) (estate that was beneficiary of defined benefit pension plan assigned interest to charity in partial satisfaction of charity's share of residue of estate; estate has no IRD from plan); P.L.R. 200002011 (Jan. 18, 2000) (charity designated as beneficiary of deferred compensation after death and nonstatutory options bequeathed to charity; no IRD to estate); P.L.R. 9633006 (Aug. 16, 1996) (tax-exempt foundation designated as beneficiary upon death of owner of Keogh qualified employer plan for self-employed; no IRD to estate). Cf. P.L.R. 9845026 (Nov. 6, 1998) (distribution of bonds to tax-exempt charity by estate did not result in IRD to estate and accrued income will be included charity's income, which is exempt from tax).

If amounts are payable on a PPVA upon death, the value of the PPVA is generally included in the decedent's gross estate for U.S. federal estate tax purposes.³¹ There is no fair market value basis step-up in the PPVA as of the date of death, in contrast to the treatment of other assets.³² Under section 691(c) of the Code, a deduction with respect to IRD is permitted for the allocable portion of estate taxes resulting from the inclusion of the PPVA in the annuitant's estate.

a. Estate Tax Deduction if Tax-Exempt Charity is Beneficiary

For U.S. federal estate tax purposes, the estate may offset the inclusion of the PPVA in the estate for estate tax purposes if the beneficiary of the PPVA is a tax-exempt charity.

Generally, for purposes of the U.S. federal estate tax, under section 2055 of the Code the value of the taxable estate is determined by deducting from the gross estate the amount all bequests, legacies, devises, or transfers to public, charitable and religious uses. The IRS has issued private letter rulings holding that the transfers of annuities to a tax-exempt charity by an estate resulted in such a deduction.³³

* * * * *

We express our opinion herein only as to those U.S. federal income tax and federal estate tax matters specifically set forth above and no opinion should be inferred as to the tax consequences of the PPVA under any state, local or non-U.S. law, or with respect to other areas of U.S. federal taxation. This opinion is based on the Code, applicable Treasury regulations, administrative interpretations and court decisions, each as in effect as of the date of this opinion, all of which are subject to change at any time, including a change applied retroactively. This opinion is based on certain assumptions and representations as to factual matters described above. If any of the assumptions or representation is incorrect, incomplete, inaccurate or is violated, the validity of the conclusions reached in this opinion may be jeopardized. This opinion represents our legal judgment but is not binding on the IRS or any court, and there can be no certainty that the IRS will not challenge the conclusions reflected in this opinion or that a court would not sustain such a challenge.

Circular 230 Disclosure

³¹ I.R.C. § 2039.

³² I.R.C. § 1014(b)(9)(A).

33 P.L.R. 200052006 (Jan. 2, 2001). The IRS has reached a similar conclusion for IRAs in which and pensions rights bequeathed to charities upon death. See, e.g., P.L.R. 200002011 (Jan. 18, 2000) (taxpayer designated charities as beneficiary of deferred compensation and bequeathed nonstatutory options to charities; value of deferred compensation and options includible in gross estate and estate eligible for deduction under section 2055(a) for the deferred compensation and value of options); P.L.R. 199939039 (Oct. 4, 1999) (tax-exempt foundations named as beneficiaries of IRAs and qualified retirement plans upon death of taxpayer; IRA and plan included in estate and estate eligible for deduction for proceeds of the IRA account and qualified retirement plan passing to foundation); P.L.R. 9818009 (May 1, 1998) (same); P.L.R. 9723038 (June 6, 1997) (IRA with charities as contingent beneficiaries after spouse—estate of the survivor of taxpayer or spouse will be entitled to deduction under section 2055(a) equal to value of IRA that passes to charities); P.L.R. 9633006 (Aug. 16, 1996) (tax-exempt foundation designated as beneficiary upon death of owner of Keogh qualified employer plan for self-employed, value of plan included in estate and estate eligible for charitable deduction under section 2055(a)); P.L.R. 9341008 (July 14, 1993) (tax-exempt foundation created by taxpayer is beneficiary of IRA, value of IRA includible in estate and estate eligible for deduction of proceeds of IRA paid to charity under section 2055(a)).

Pursuant to U.S. Treasury Department Circular 230, we advise you that to the extent that this opinion is used or referred to in promoting, marketing or recommending investment in or arrangement with respect to a PPVA to any person (A) the advice in this opinion was not intended or written by us to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer, (B) the advice in this opinion was written to support the promotion or marketing of the transactions or matters addressed by this opinion; and (C) a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. With respect to any particular owner of a PPVA, additional issues may exist that could affect the federal tax treatment of a PPVA or other matter that is the subject of this opinion and this opinion does not consider or provide any analysis with respect to any such additional issues.

R.L.R.

D.J.M.

C.A.H.

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