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If any of your clients have discussed with you an investment vehicle which offers tax deferred accumulations, fully guaranteed principal with high interest guarantees, liquidity, lifetime and retirement income options and the avoidance of probate in the event of death, then, they were probably referring to some form of a deferred annuity.

In a recent, broad scale attack, the Internal Revenue Service struck down certain types of tax deferred annuity plans, including certain "wraparound" annuitites that invest in money market mutual funds.

A deferred annuity, as opposed to an immediate delivery, allows the purchaser to accumulate earnings tax free during the deferral period. This device permits an individual to save money and to avoid current taxation of the earnings from his investment because the account value, or corpus of the annuity contract, is not considered to be an amount actively or constructively received by the taxpayer under I.R.C. §72(e)(1982). This section provides that amounts received by the owner of the contract during the accumulation period (but not as an annuity payout) is taxable as ordinary income at the redemption or surrender of the contract. The owner of the annuity will only be taxed on the payments ultimately received from the annuity but will not be taxed on the income as it is currently earned.

Once the annuity commences on the annuity starting date, i.e. during the payout period when the annuitant begins to receive his annuity payments, I.R.C. §72(a)(b)(1982) provides that a part of each year's annuity payments is excludible from gross income as a tax free return of the annuity purchase contribution. This provision is known as the "general annuity rule." The balance of the annual sum received is taxable as ordinary income.

A "variable" annuity, as opposed to a "fixed" annuity, is one where the periodic payments increase or decrease depending upon the investment performance of the underlying assets held in a separate account (rather than the general asset account of the insurance company) and various other fluctuating criteria throughout the lifetime of the annuitant. It could be one of the most practical ways of establishing a hedge against inflation.

A "fixed" dollar annuity is one where the periodic payments remain fixed as to dollar amount for a certain period throughout the lifetime of the annuitant. A fixed account deferred annuity can afford the highest possible yield with the maximum number of guarantees and optional means of utilizing funds. An individual can minimize the impact of taxes and risk and can eliminate income taxes and probate costs in the event of death before the annuity payout period begins.

Whether the investor chooses a fixed dollar or a variable dollar contract will depend on such factors as his investment objectives, his tax bracket, the risks involved, his financial circumstances, his personal preference, and the effects of inflation.

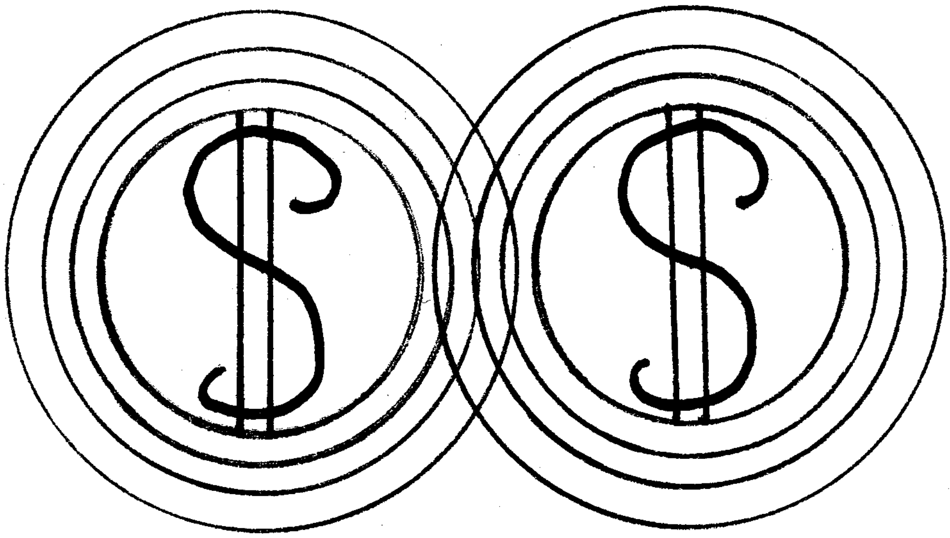
In recent years, a popular vehicle known as a "wraparound annuity" or "investment annuity" became widely used as a creative planning device for the tax deferred accumulation of current gains through the purchase of mutual fund shares or other investments with the premiums from a variable annuity. A wraparound annuity is a kind of a variable annuity. It is another form of deferred annuity, but is distinguished from an ordinary deferred annuity in that the assets are invested in a special fund or separate account by the insurance company. The desired effect is to permit an individual to deposit funds through an insurance company annuity contract into one or more investments, to exercise substantial control over the investment decisions, and, at the same time, to retain the advantageous tax status of an ordinary deferred annuity. This would allow the annuity owner to be taxed, under I.R.C. § 72 (1982), when the payments are ultimately received under the annuity. The income earned prior to the annuity payout would accumulate tax deferred. Since the funds being invested are "wrapped" by an annuity contract, income tax is deferred on the inside buildup of interest and equity appreciation.

When annuity payments are ultimately made to the annuitant the income will vary with the value of the underlying investments. The annuity owner, in assuming the investment risk, is hopeful that the yield from the investment in the underlying fund shares will exceed the income guaranteed by an insurance company had he purchased a traditional, guaranteed fixed income annuity.

The status of the wraparound annuity for purposes of the federal income tax was first drawn into question by the Internal Revenue Service in Revenue Ruling 80-274, 1980-2 C.B. 27, which dealt with "saver annuities" wrapped around certificates of deposit offered through federally insured savings and loan associations principally located in the midwest and southwest. In this situation, the insurance company and the participating savings and loan institutions executed an agreement which provided for the participants to act as the group contract holder of an annuity plan. The insurance company then sold annuity contracts to depositors of the participating institutions. The depositor would transfer his certificate of deposit, savings account or cash to the insurance company in exchange for an annuity contract. The net amount, after sales charges and administrative expenses, was deposited into the depositor's savings and loan account, and then invested in a certificate of deposit on behalf of the depositor. The underlying premise of the "saver annuity" plan was that the buyer of the annuity, the depositor, could avoid paying taxes on the current income from the certificate of deposit, because the only thing he actually owned was the annuity contract. The Internal Revenue Service ruled, however, that the position of the annuity owner was substantially identical to what it would have been had the investment been made directly with the savings and loan association, and that since the annuity purchaser had control over the way in which the money was invested, the purchaser, rather than the insurance company, must be considered the owner of the certificate for income tax purposes as required by I.R.C. §61(a)(1982).

This ruling was consistent with Revenue Ruling 77-85, 1977-1 C.B. 12, an earlier ruling, which provided that an annuity contract, marketed as an "investment annuity," which permitted the policyholder to direct how his payment to the annuity company would be invested by the company, would result in the investment return being taxed currently to the policyholder rather than to the insurance company. This case dealt specifically with a program under which a segregated asset account known as a "custodial account" was established for each investment annuity contract. I.R.C. §801 (g) (1) (B)(1982) provides that where such an account is established, the income from the assets are taxed to the insurance company as an operational gain. This gain, or loss, can be described as the gain or loss for the taxable year to the insurance company determined by its investment field, less appropriate deductions as described in I.R.C. §809 (b) (1982). The policyholder, rather than the insurance company, however, retained the power to direct how the assets in the custodial account were to be invested, thus effectively retaining investment control over his money.

While the later ruling was limited to annuity wrappers involving certificates of deposit, it turned out to be one of the underpinnings of Revenue Ruling 81-225, 1981-41 I.R.B. 5 which contends that the purchasers of certain mutual fund annuities also control how their money is invested.



There were a number of annuity plans that provided investors with the flexibility of several investment options. An investor could move from one fund to another within the annuity, for example, from a bond fund to a money market fund, to satisfy his investment needs, while continuing to tax shelter certain income.

This decision, published in October of 1981, addresses five separate fact situations to determine whether the insurance company issuing variable annuity contracts purporting to allow tax deferred accumulations to the purchaser, or the policyowner, would be considered the owner of the mutual fund shares for federal income tax purposes. In each of the situations, the individual purchased a deferred variable annuity contract.

In the fact situation where the Service held that the insurance company, rather than the annuity purchaser, was considered the owner for federal income tax purposes, the individual had purchased a deferred variable annuity where the net premium received by the insurance company was allocated to the company's variable account, the assets of which were invested in a mutual fund. In this case, the fund shares were not separate investment assets, but an investment vehicle which would allow the insurance company to meet its obligations under the annuity contract. Since for income tax purposes, a transaction of this nature would be the equivalent of a direct purchase of the mutual fund shares by the insurance company, the company would possess the required incidents of ownership to be considered the owner of the underlying mutual fund assets for federal income tax purposes.

This mutual fund was managed by the insurance company or its affiliate under an investment advisory and administrative service contract. The mutual fund shares, however, were not sold to the general public and were available only by the purchase of an annuity contract from that specific insurance company. The earnings and gains from shares allocated to the annuity contract were, therefore, not includible in the gross income of the owner of the variable annuity contract under the requirements of I.R.C. §61 (a)(1982).

In explaining this ruling, the Service referred to the earlier ruling which held that the purchaser of an annuity contract who could select and control one or more of the annuity investments would be considered the owner of the underlying investments for federal income tax purposes.

Under the facts of both the earlier ruling, 77-85, and the later ruling, 80-274, where the insurance company placed the net premiums in a savings and loan certificate of deposit for a term designated by the annuity owner, the Service concluded that the annuity purchasers "possessed sufficient incidents of ownership" to be taxed on the income from the underlying investments. By determining that investors should not be allowed to enjoy tax deferred accumulation status by "merely wrapping" identical mutual fund shares, otherwise available to the general public on a taxable basis, the Service clearly and effectively barred the tax deferral of gains from those annuities where the owner maintains investment control and possesses sufficient incidents of ownership to be considered the owner of the underlying mutual fund shares.

In a surprise move, unexpected by the insurance community, the 1981 rule was made effective retroactively to bring under the ruling annuity owners whose premiums were made to the insurance company after December 31, 1980. Further, this holding also applies to those annuity contracts entered into after September 25, 1981, that qualify as tax deferred annuities for teachers and charity workers, individual retirement annuities and qualified retirement plan annuities under I.R.C. §403(b), 408(b) and 403(a)(1982).

In light of the rulings and in view of the popularity of the wraparound annuity, many insurance companies have endeavored to develop annuity plans where the underlying investments in mutual fund shares are controlled by the insurance company, and where the shares in those mutual funds are limited to the annuity owners. This has resulted in the establishment of "clone funds" in order to satisfy Revenue Ruling 81-225. This would limit the selling of the shares of the "clone fund" or other similar investments to the purchasers of the particular insurance company's annuity contract, thus complying with the rules and achieving the desired objective of tax deferred accumulations. If the fund can only accept investments via the purchase of the insurance company's wraparound annuity, and the annuity owner has no power to select or control any investments, the vehicle complied with the rulings annuity purchasers "possessed sufficient incidents of ownership" to be taxed on the income from the underlying investments.

Revenue Ruling 81-255 also left uncertain the question of whether it was permissible to provide for multiple funds under a single contract, and whether transfers of deposits among funds under the contract were or were not taxable events. In view of the uncertainty, one major insurance company introduced an annuity plan that provides for a separate annuity wrapper contract for each fund utilized. Thus, an individual could purchase a "bundle" of annuity contracts with each contract applying to one fund. The annuity owner would be able to select the fund into which his deposits would be invested, and, in addition, should be able to transfer funds from one annuity contract to another without incurring a taxable event.

In order to clarify certain questions raised concerning Revenue Ruling 81-225, the Internal Revenue Service announced two new rulings. These rulings concern whether life insurance companies or their policyholders are considered the owners, for federal income tax purposes, of mutual fund shares held by the companies in connection with wraparound annuities. Revenue Ruling 82-54 1982-14 I.R.B.5 holds that the use of a multi-funding concept as a funding vehicle for annuities will not disqualify the annuities under 81-255, provided that the fund is closed to the public and managed by a related investment advisor. Revenue Ruling 82-55 1982-14 I.R.C.6 holds that purchasers of annuity contracts whose funds are invested in mutual funds which were closed to the public prior to the purchase will not be treated as the owners of those mutual fund shares.

The Internal Revenue Service has, therefore, established that earnings on fund shares may be accumulated without being currently taxed to the annuity owner as long as the investments made by the amounts paid into the contract are in the insurance company's wraparound annuity only. As a further requirement, as long as the annuity owner retains no power to select or control any of the underlying investments, this tax deferral will be permitted. Although the tax advantages could be formidable under a qualified wraparound annuity, they should not be the sole criterion for such a purchase. Clients should be reminded that the annuity was originally designed as a device for providing income to an annuitant that he or she could not outlive. Furthermore, it should be understood that the wraparound annuity is currently being utilized essentially as an investment vehicle. As such, it is subject to the ups and downs of the economy, and may not provide an income that is sufficient for a specific client's purposes, since the expected earnings may not be realized. Therefore, the quality of the investment, as well as the tax deferral opportunity should be carefully evaluated, as should the availability of fixed guarantee annuities that may better suit the needs and comfort levels of some less adventuresome clients who absolutely require a fixed amount of income at a certain point in time and are unwilling or unable to take investment risks.