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# ERODING THE TAX BENEFITS OF WRAP-AROUND ANNUITIES: AN ANALYSIS OF REVENUE RULING 81-225

## INTRODUCTION

Certain aspects of life seemingly never change. Just as the cat is constantly chasing the mouse, the IRS is constantly chasing those who market various forms of annuity contracts. The most recent and perhaps the boldest attempts to restrict the tax benefits of annuity contracts occurred in Revenue Ruling 81-225.[1] In the Revenue Ruling, the service took the position that owners of qualified and non-qualified variable annuities that are "wrapped around" mutual funds available to the general public are not entitled to the special tax treatment generally accorded annuities. Revenue Ruling 81-225 resurrects the issue of which contractual relationships will be considered annuities for the purposes of federal taxation. In addition, a more subtle issue is raised: should non-qualified deferred annuities be restricted to a retirement, rather than an investment, function?

Recent controversy has centered around what access and control the policy holder may retain with respect to the transferred funds without losing advantageous tax treatment. The Service maintains that annuity contracts should be tested under the tax ownership theory of *Clifford v. Helvering*.[2] This reflects a policy objection to the use of non-qualified annuities as an investment rather than retirement device.

The law in this area is chaotic. There is little legislative guidance and the controlling Revenue Rulings are of questionable validity. This paper will examine the federal tax treatment of non-qualified annuities and then discuss the evolution of the present controversy. A consideration of the future use of non-qualified annuities will conclude the paper.

## DEFINITIONS

While the Internal Revenue Code does not define the term annuity, the regulations under section 72 provide basic identification principles. An annuity is a contract providing for periodic payments to a named payee. Such payments must commence after a certain date,[3] called the annuitization date, and extend

1. Rev. Rul. 81-225, 1981-41 I.R.B. 19.

2. 309 U.S. 331 (1940). *Clifford* involved the issue of how much control a grantor may retain over assets transferred into a trust. The Court considered several factors, including the grantor's power to sell corpus assets and reinvest the proceeds without restriction and reversion of the corpus at the end of a five year term. The Court concluded that the grantor, not the trust, was the tax-owner of the transferred assets. The issue of tax ownership in the grantor-trust area is now governed by I.R.C. §§ 671-678 (1976); *Clifford's* logic is clearly applicable to annuities. Like a trust arrangement, an annuity involves a transaction in which the taxpayer attempts to transfer tax-ownership of certain assets to another taxpayer, an insurance company.

3. The date upon which the periodic payments begin is the date of "annuitization." This is also referred to as the annuity starting date.



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for any period greater than one year.[4] This promise is generally acquired by the transfer of consideration. The periodic payments consist of both a return of capital and income earned during the period between contract formation and the time payments begin.[5] Because the payments are to continue for a specified period measured by a number of years,[6] or measured in terms of a particular life,[7] mortality factors are involved.[8]

Annuity contracts may be commercial or private. Commercial annuities are issued by insurance companies,[9] whereas private annuities involve contractual relations created between individuals in a non-commercial setting.[10] This paper deals solely with commercial annuities.[11]

Commercial annuities may be further classified according to the nature of the issuer's obligation. A conventional fixed-dollar annuity is a promise by the issuer to pay a fixed amount at periodic intervals after annuitization. The policy holder transfers the premium to the issuer who creates a reserve for fixed annuities.[12] Under this arrangement, the insurer has both the risk and the benefit of the investment experience of the policyholder's funds while guaranteeing the policyholder a certain rate of return. In a variable annuity contract, the insurer does not guarantee a specific rate of return;[13] instead the policyholder's return is dependent upon the investment experience of his account.[14] The policyholder transfers funds to the insurer who invests those

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4. Treas. Reg. § 1.72-2(b)(2)(ii) (1956).
5. *See infra* note 25.
6. An annuity may provide for a payout that will occur in all events over a certain term.
7. Under a single life annuity, payments commence at a specific date, such as age 65, and continue until the death of the annuitant. A joint and survivor annuity is similar to a single life annuity except that payments will continue for the life of a named beneficiary after death of the annuitant. For the tax treatment of annuity payments, see *infra* note 25.
8. "Each issuer assumes the risk of mortality from the moment the contract is issued. That risk is an actuarial prognostication that a certain number of annuitants will survive to specified ages. Even if a substantial number live beyond their predicted demise, the company issuing the annuity — whether it be fixed or variable — is obligated to make the annuity payments on the basis of the mortality prediction reflected in the contract." SEC v. Variable Annuity Ins. Co., 359 U.S. 65, 70 (1959).
9. I.R.C. § 801(a) defines "Insurance Company."
10. Vernava, *Tax Planning for the Not-So-Rich: Variable and Private Annuities,* 11 WM. & MARY L. REV. 8, 8 (1969).
11. Thus far, the Service has focused its attention on commercial annuities. However, the Service's arguments involving "incidence of ownership" based upon *Clifford* notions are clearly applicable to private annuities as well. Further, the alleged tax abuses which the IRS finds objectionable in the commercial field are equally possible in the private annuity area. Any legislative solution to annuity problems should encompass both private and commercial annuities.
12. Such reserves are often required by state insurance law. *See, e.g.,* FLA. STAT. § 625.121 (1981).
13. Annuities may combine fixed and variable characteristics. For example, an annuity may guarantee a low minimum rate of return or tie the maximum return to the investment experience of the annuitant's account.
14. Variable annuities are sanctioned in I.R.C. § 801(g)(1)(A) (1976).

funds in various forms of equity.[15] The account is credited by income earned during the accumulation period.[16] Payments commencing upon annuitization reflect both the earned income and market value of the policyholder's account. The variable annuity shifts the risk of investment to the policyholder,[17] and may operate as a hedge against inflation.

Both types of annuities may be immediate or deferred depending upon the annuitization date. Under an immediate annuity, payments to the policyholder commence within a short period after the transfer of funds to the issuer. A deferred annuity involves an accumulation period between the policyholder's transfer and annuitization. Variations of the deferred variable annuity have triggered IRS reaction.

## FEDERAL TAX TREATMENT OF ANNUITIES

### *The Policyholder*

There are no tax consequences to a policyholder when cash is transferred to purchase an annuity contract. If, however, the policyholder transfers appreciated property to the issuer, taxable gain or loss will result under I.R.C. § 1001.[18] During the accumulation period, income earned and credited to the policyholder's account is taxable to the insurer at marginal rates,[19] rather than to the policyholder.[20] Because most annuity contracts contain the right to both partial and total cash surrender,[21] constructive receipt principles[22] would seem to govern, absent a penalty for exercise of the cash surrender option.

There is a strong reason for the inapplicability of constructive receipt theory to income earned during the accumulation period. By legislative grace, Congress has consistently taxed amounts in excess of the invested funds only

15. The underlying investment is normally in corporate equities so the policyholder's account will hopefully keep pace with inflation.

16. These amounts are typically adjusted for charges incurred in maintaining the account.

17. In a pure variable annuity, the policyholder assumes the risk that the return on his account might not keep up with inflation. By contrast, in a fixed annuity setting, the insurer bears the risk of investment because the rate of return is guaranteed. *See* Investment Annuity, Inc. v. Blumenthal, 442 F. Supp. 681, 690-91 (D.D.C. 1977), *rev'd*, 609 F.2d 1 (1979), *cert. denied*, 446 U.S. 981 (1980).

18. *See* Skipper, *The Investment Annuity*, 33 C.L.U.J. 11, 14 (1979).

19. For a summary of the complexities of life insurance company taxation, see Kaufman, *The Life Insurance Company Income Tax Act of 1959*, 16 NAT'L TAX J. 337 (1963).

20. The standing principle of annuity taxation is that the return above the annuitant's investment will not be taxed until the payout begins. *See generally*, Vernava, *supra* note 10, at 10-12 (given a detailed description of the history of taxation upon annuitization).

21. The district court in *Investment Annuity, Inc.* stated that that the annuity contract at issue was virtually identical to all variable annuities, varying in only certain respects. The partial cash surrender option was not listed as a difference, nor was existence of that right objectionable to the court. 442 F. Supp. at 690-91.

22. Treas. Reg. § 1.451-2(a) (1965) (generally, a taxpayer is taxed on income not actually received when the income is earned, set aside for the taxpayer and receipt is not subject to any substantial limitations.)

when payout commences.[23] Thus the statute, rather than constructive receipt theory, governs the taxation of investment income to the annuitent.[24]

Upon annuitization the deferral continues during the payout period. I.R.C. § 72(a) requires amounts received under an annuity contract in the tax year in excess of the excludable portion to be included in gross income. Section 72(b) provides a ratio for determining the excludable amount.[25] Since this formula provides for a ratable recovery of capital, it results in spreading taxation of the earned income over the payout period. Each year the entire includable amount is taxed as ordinary income;[26] thus the price for the tax deferral is the loss of the I.R.C. § 1202 capital gain deduction that would have resulted if the same money was invested in capital appreciation property. In sum, if the contract is an annuity, the resulting deferral of income may yield significant tax savings if the policyholder is in a lower tax bracket during the payout period than during the accumulation period.

### *Tax Impact to the Insurance Company*

The I.R.C. § 801(a) definition of a life insurance company requires that the "company's life insurance reserves" plus other amounts exceed 50 percent of total reserves. Life insurance reserves are defined by section 801(b) as reserves based on mortality tables that are set aside for contracts including annuities. Most variable annuity contracts require section 801(g)(1)(B) reserves based upon segregated asset accounts, and these qualify as section 801(b) reserves. Thus, a company issuing only annuities will qualify as a life insurance company.

Determining whether the issuer is a "life insurance company" for the purposes of federal taxation is critical.[27] Under the special taxation scheme of I.R.C. § 802,[28] a life insurance company's investment income is taxed at a

23. I.R.C. § 72(a), (b) (1976). For a history of the various methods employed by Congress to tax the amount in excess of the annuitant's investment see Vernava, *supra* note 10, at 10-12.

24. Bulova Watch Co. v. United States, 365 U.S. 753, 761 (1961). This was cited by the marketer on appeal. Brief for Appellant 48, Investment Annuity, Inc. v. Blumenthal 609 F.2d 1 (D.C. Cir. 1979), *cert. denied,* 446 U.S. 981 (1980).

25. I.R.C. § 72(a) (1976) provides the following formula for determining what portion of an annuity payment is a non-taxable return of capital:

$$\frac{\text{Total investment in the contract}}{\text{Total expected return}} \times \text{payments received} = \text{Non-taxable return of capital}$$

Any amount received in excess of the excluded amount is taxed as ordinary income. This ratio applies to all payments regardless of whether the taxpayer dies before recovering the investment, or outlives the assumed life expectancy and receives payments which do not represent return of capital. Waller v. Commissioner, 39 T.C. 665, 678-79 (1963).

26. I.R.C. § 72(a) (1976). The amounts are considered as interest even though they might be attributable to appreciation of capital assets.

27. *See* Kaufman, *supra* note 19, at 337. "Life insurance companies are generally classified as 'financial intermediaries,' institutions which act as a medium of savings for individuals and as a source of investment funds for the economy. Unlike other intermediaries, which hold deposit type savings, life insurance companies perform the long term function of providing financial protection." *Id.*

28. I.R.C. § 802(a)(1) (Supp. II 1978) states that to the extent of a life insurance

marginal rate. Thus there is a minimal charge to the policyholder's account[29] and no double taxation when the policyholder subsequently receives the earned income in annuity payments taxed under I.R.C. § 72. In conjunction with section 72, section 802 operates to defer tax on earned income, thereby increasing the attractiveness of annuity investments. If the company does not qualify as a life insurance company, however, the investment income would be taxed under ordinary corporate rates,[30] and the tax would be passed through to the policyholder thereby defeating the annuity's deferral of income.

The interplay between the insurance taxation provisions and section 72 is completely dependent upon the contract qualifying as an annuity. The remainder of this paper will trace various attempts by annuity marketers to increase the investment utility of an annuity and the Service's attempt to counter these developments.

### *Developing Confusion: Prelude to Revenue Ruling 77-85*

The first major conflict between the Service and the annuity industry involved investment annuities. In an investment annuity, the policyholder transferred funds to a third party custodian, and could make additional transfers at any time prior to annuitization. The policyholder also had the option of transferring stocks or bonds from an existing portfolio directly into the custodial account.[31] The custodian was required to invest the funds, at the policyholder's direction, among a group of issuer approved investments.[32] Additionally, the policyholder retained the right to direct the custodian to sell assets and reinvest the proceeds among investments on the approved list during both the accumulation and the annuitization periods. The policyholder had the option of terminating the contract in whole or in part and receiving a cash surrender value less a charge for termination. This option ended upon annuitization. An important feature of the cash surrender right

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company's taxable income, the tax imposed shall be that of a normal corporation. The preferential treatment of life insurance company taxation is found in the definition of "life insurance company taxable income" under I.R.C. § 802(b) (1976). Basically, the life insurance company is taxed at a reduced rate on investment income due to the operation of I.R.C. § 804 (1976) and I.R.C. § 805 (1976 & Supp. II 1978) through § 802 (1978). For a summary of this complicated area of taxation, see Kaufman, *supra* note 19. For a more detailed analysis see, T. NASH, 1 FEDERAL TAXATION OF LIFE INSURANCE COMPANIES, § 8.01 (1971).

29. *See supra* note 16.

30. I.R.C. § 11 (Supp. II 1978) as amended by Economic Recovery Tax Act of 1981 § 231a.

31. This would trigger I.R.C. § 1001 (1976) and gain or loss would result. See *supra* text accompanying note 20.

32. Investments approved by the First Investment Annuity Company of America included: securities listed on the New York Stock Exchange; mutual funds; United States and Canadian Government Bonds; certificates of deposit; savings accounts; debt instruments of corporations which would reasonably be expected to be listed on an exchange regulated by the Securities Exchange Commission; commercial paper; term life insurance; and any other asset which met the company's standard for acceptibility, which basically required a regular market in the asset. FIRST INVESTMENT ANNUITY CO. OF AMERICA, INTRODUCTION TO THE INVESTMENT ANNUITY 8 (1974).

was that the policyholder was only entitled to receive cash, and could never obtain the assets contained in the annuity.

Such arrangements came to be known as a "wrap around" annuities. By maintaining an investment portfolio through an annuity contract, the investments were wrapped in the tax deferral accorded to annuities.[33] The policyholder had effectively sheltered income producing investments from current taxation.

The initial cost of this arrangement was significant. The policyholder was charged a percentage of the cumulative contributions to the account. The loading charge varied by company. In 1975 the fee ranged between three and five percent,[34] which was a significant charge because the average minimum contribution required was about $10,000.[35] The policyholder was also charged an annual premium and custodian fee which averaged about one percent of the accumulated contributions per year.[36] The loading charge and annual premiums were non-refundable. Thus, a policyholder wishing to exercise the cash surrender option to obtain his account balance would incur an economic loss.

During the twelve year period from 1965 through 1977 the Service issued about seventy favorable letter rulings approving beneficial tax treatment for investment annuities.[37] The rulings stated that reserves attributable to investment annuities qualified as life insurance reserves for the purposes of section 801(b), thus qualifying the marketer for insurance company taxation. The rulings further held that the policyholder was not the owner of the assets in the account and hence not taxable on the current income.[38]

These "investment annuities" were not immediately accepted by investors. By the mid 1970's, however, their sales skyrocketed. They were marketed for high-tax bracket individuals seeking deferral of income from income earning assets while retaining investment control.[39]

Another important aspect of the investment annuity was that its utility was limited mainly to income producing assets rather than capital appreciation property. The initial problem was that if a taxpayer transferred an appreciated asset into his account, I.R.C. § 1001 would be triggered, and taxable gain

33. "The investment annuity, in other words, is attractive chiefly to the well-to-do individual primarily interested in accumulating income under a tax-deferred umbrella." Anreder, *Attractive "Wrapper" — The Investment Annuity Has Begun to Catch On*, BARRONS NAT'L BUS. & FIN. WEEKLY, Nov. 17, 1975 at 3.

34. *Id.* The highest percentage for the contribution in 1974 was 4% for First Investment Annuity Company's non-qualified annuity. This percentage, however, applied in the $10,000-$249,999 cumulative contribution range. Thus, the policy required a fairly significant front load. FIRST INVESTMENT ANNUITY CO. OF AMERICA, PERSONAL INVESTMENT ANNUITY POLICY 11 (Sept. 1974).

35. Anreder, *supra* note 33, at 14.

36. *Id.* at 20.

37. In debate, Senator Allen put the number of favorable private letter Rulings at seventy. 123 CONG. REC. 12,933 (1977).

38. *See* Brief for Appellee at 6-7, *Investment Annuity, Inc.*

39. *See* Anreder, *supra* note 33, at 20. Given the high minimum contribution required about $10,000, it was clear that these policies were designed for the wealthy. *Id.* at 14.

would result.[40] More importantly, if the policyholder directed the sale of an asset, the insurance company would be taxed on any resultant gain and the account would be decreased by the amount of tax liability generated.[41] The investment annuity thus sheltered income production, but not taxable gains.

### *An About Face: Revenue Ruling 77-85*

In 1977 the IRS reversed its position on the tax treatment of the investment annuity in Revenue Ruling 77-85.[42] The Service took the position that the control retained by the policyholder supported the conclusion that the policyholder is the true tax-owner of the "wrapped" assets and should be taxed currently on income earned under section 61.[43] There had been no change in statutory or judicial tax law in the annuity area during the twelve year period prior to this Revenue Ruling, thus the IRS action was simply a reversal of administrative policy.

The ruling effectively slammed the door on the investment annuity. With the special tax treatment uncertain, companies could no longer market such a contract.[44] The issuers of these annuities immediately petitioned Congress to pass legislation suspending Revenue Ruling 77-85 for one year allowing them time to urge permanent legislative reversal of the Ruling.[45] Those favoring

40. See *supra* text accompanying note 18.

41. This would pass the tax liability through to the annuitant, defeating the tax deferral objective. The following example illustrates the result:

| | |
|---|---|
| Assumed long-term capital gain realized within the Segregated Asset Account | $1,000 |
| Insurer's long-term capital gains tax* charged against the account | 300 |
| Net after tax balance or realized gain | 700 |
| When balance above is paid out as benefit or cash surrender value it is taxable to the individual at ordinary income tax rate – Balance above paid out as annuity benefit or cash surrender value | 700 |
| Individual's assumed tax [assumed tax rate – 32%] | 224 |
| Individual's net after tax balance | 476 |

*[Insurer's tax rate: 48% short term; 30% long term]

In the above example, the individual lost 52.4% of the realized gain [$524 of $1,000] to taxes whereas the same $1,000 gain would have been taxed only once at 16% [½ of the individual's ordinary rate of 32%] if the gain had been incurred by the individual directly. Obviously, individuals in higher tax brackets would receive even less after-tax benefit.

The purchase of an Investment Annuity enjoys no tax deduction of purchase price. Realized capital gains within an Investment Annuity Segregated Asset Account are subject to onerous double taxation (as illustrated above) and investment income is merely tax deferred in exactly the same way as any cash value life insurance policy, any fixed dollar annuity policy or any variable annuity policy issued by any life insurer in the United States.

123 CONG. REC. 12,936 (1977).

42. 1977-1 C.B. 12.

43. The revenue ruling contained a grandfather clause which allowed a continuation of the preferential tax treatment to taxpayers who had purchased investment annuities prior to March 9, 1977; however, such taxpayers were not allowed to make any additional contributions. *Id.* at 15.

44. One company in this position was First Investment Annuity Company of America.

45. Revenue Ruling 77-85 adversely affected companies relying on the investment annuity market.

the Ruling's position, however, viewed the investment annuity as an investment vehicle much the same as a mutual fund.[46] Opponents of the proposed legislation argued that by allowing investment annuities tax deferral under sections 801 and 72, Congress would subsidize a form of investment competing with mutual funds, thereby damaging the mutual fund market.[47] The proposal to reverse Revenue Ruling 77-85 was rejected and Congress thus failed to resolve the underlying controversy.

*The Industry Reacts:* Investment Annuity Inc. v. Blumenthal

After the rejection of the proposed legislation, an annuity marketer sought a declaratory judgment that Revenue Ruling 77-85 violated the Internal Revenue Code, and injunctive relief to prevent application of the Ruling. In *Investment Annuity Inc. v. Blumenthal*,[48] the district court found the Ruling invalid. The court held that section 801(g)(1)(B) and its legislative history did not support or deny the position taken in Revenue Ruling 77-85. The court also rejected the Service's argument that the policyholder retained enough control to trigger *Clifford* tax ownership notions, since it felt that a "substantial change" in the policyholder's economic position had occurred when an investment annuity was purchased.[49] Impressed with the fact that the Revenue Ruling was a reversal of long standing policy, which was not justified by any change in the tax law, the court concluded that the ruling was unenforceable.

On appeal, the United States Court of Appeals for the District of Columbia reversed on procedural grounds.[50] The circuit court never reached the substantive tax issues, thus, Revenue Ruling 77-85's validity is precarious. The district court decision which declared the ruling invalid is of little precedential value due to reversal on procedural grounds; however, the decision cannot be ignored.

*The Service Steps up the Attack: The 1978 Proposal*

Simultaneous with its assault on the investment annuity, the Service attacked non-qualified, deferred annuities in general. The Treasury included a proposal in the Revenue Act of 1978 to eliminate deferral of income earned during the accumulation period of any fixed or variable non-qualified deferred annuity.[51]

46. 123 CONG. REC. 12,932-37 (1977).

47. Interestingly, it was not pointed out that the market for mutual funds would also benefit from the investment annuity. Mutual funds are an income producing investment perfectly suited for purchase through an investment annuity contract.

48. 442 F. Supp. 681 (D.D.C. 1978).

49. *Id.* at 691.

50. Investment Annuity, Inc. v. Blumenthal, 609 F.2d 1, 7-8, 10 (D.C. Cir. 1979). Essentially, the circuit court avoided the substantive tax issues and stated that only a policyholder would have standing to challenge the ruling.

51. The text of this proposal is contained in: *The President's 1978 Tax Reduction and Reform Proposals: Hearings on the President's 1978 Tax Program Before the House Comm. on Ways and Means, Part 1 of 9*, 95th Cong., 2d Sess. 291-303 (1978) [hereinafter cited as

The proposal emphasized the Service's position that annuities had been given preferential tax treatment only because of their "traditional role" as a retirement vehicle.[52] The Treasury asserted that the annuity's role had switched from retirement vehicle to tax shelter. Although the proposal was particularly critical of investment annuities, the aim was to foreclose preferrential treatment for all non-qualified deferred annuities due to the perceived shift in use.[53]

The proposal further emphasized that non-qualified deferred annuities are viewed as an impediment to the comprehensive retirement systems offered under qualified deferred compensation plans.[54] The logic was that a highly compensated individual could circumvent the rules prohibiting qualified retirement plans from discriminating in favor of officers, shareholders or highly compensated individuals[55] by simply purchasing a non-qualified annuity outside the retirement plan.[56] This logic is erroneous since anyone employed, self-employed or otherwise has the option of enhancing retirement income through an annuity. What the Treasury was really objecting to was that these annuities may be utilized as tax sheltered investments.[57]

The Treasury proposal was rejected in committee, thus there is no legislative history from which congressional intent could be gleaned.[58] *Investment Annuity* and congressional inaction generated such uncertainty that the investment annuity industry had effectively ceased to exist by mid-1978. Despite this, and the Service's continued hostility toward all non-qualified deferred annuities the annuity industry responded with new variations.

### *The Industry Responds: New "Wrappers" are Born*

Since the tax deferral aspect of investment annuities had been so popular, annuity marketers designated new investment plans to produce the same effects as the investment annuity. These new annuities basically replicated the investment annuity with minor changes to appease the Service. The goal remained the same: wrap an income producing asset such as shares in a mutual fund in an annuity and apply sections 801 and 72 to shelter income earned by the wrapped assets from current taxation.

At the core of the new annuities were mutual funds and other investment groupings. Some accounts allowed the policyholder to shift between various investment groupings;[59] others were more conservative, allowing the policy-

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*Hearings*]. It is important to note that the Treasury expressly exempted annuities under qualified plans from the amendment. *Id.* at 299.

52. *Id.* at 292.

53. *Id.* at 292-97.

54. *Id.*

55. *See* I.R.C. § 401(a)(4) (1976).

56. *Hearings, supra* note 51, at 298.

57. See *supra* text accompanying note 55.

58. One observer felt that intense lobbying by the insurance industry was responsible for the committee's decision. Washington Post, Apr. 30, 1978, at F1, col. 6.

59. *See* Rev. Rul. 81-225, 1981-44 I.R.B. 19, 20.

holder to switch only between a mutual fund account and a no-risk fund invested primarily in government and triple A industrial bonds.[60] The theory behind using mutual funds was that the mutual fund manager, not the policyholder, controlled the investment portfolio. The Service seemed to accept this distinction, and these annuities were granted favorable letter rulings.[61]

Soon, annuity contracts were offered as a method of deferring tax on income earned by investments traditionally offered by savings and loan institutions. Under these arrangements, the policyholder would transfer funds to an insurer in exchange for an annuity contract. The insurer would then transfer the amounts to a bank which would invest the proceeds in a certificate of deposit or a mutual fund. The policyholder's contractual relation was entirely with the insurer and not with the bank. The policyholder could withdraw the funds, less a penalty, if there was a penalty for early withdrawal imposed by the savings and loan association. Initially, the Service approved these annuities on the investment control distinction.[62]

### *The Service Strikes Back: Revenue Ruling 80-274*

The Service reversed itself again, and denied favorable tax treatment for the savings and loan annuity in Revenue Ruling 80-274.[63] The Service stated that the policyholder is taxable on income earned by the wrapped assets under section 61 because of the retention of "substantial incidents of ownership." In the 1980 ruling, an extension of Revenue Ruling 77-85, the Service did not cite investment control as a rationale for its conclusion. The situation described in Revenue Ruling 80-274 involved an initial investment in a certificate of deposit or mutual fund with no power to switch investments. The Service stated that the policyholder's investment in the certificate of deposit through the annuity is identical to that of an individual investing in a certificate of deposit directly through a bank.[64] The Service attacked a single asset wrap-around annuity to clarify its message: Revenue Rulings 77-85 and 80-274 stand for the proposition that annuity treatment will not be accorded to transactions which are designed primarily to shield investments from current income taxation.

### *The Circle is Closed: Revenue Ruling 81-225*

Combining the logic of Revenue Rulings 77-85 and 80-274, the Service completed its attack on wrap-around annuities in Revenue Ruling 81-225.[65] This Ruling was designed to prevent investors from having the option of

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60. *See, e.g.,* THE VARIABLE LIFE INS. CO., SEPARATE ACCOUNT ONE, GROUP UNIT PURCHASE VARIABLE ANNUITY CONTRACTS, PROSPECTUS (Apr. 30, 1981) (offered under a § 403(b) plan).

61. *IRS Does About Face, Attacks "Wrap-Around" Annuities,* 53 J. TAX'N 361, 362 (1980).

62. *Id.*

63. 1980-2 C.B. 27.

64. *Id.* at 28.

65. 1981-41 I.R.B. 19.

purchasing mutual fund shares through an annuity to produce tax deferral. A detailed discussion of this ruling is required to understand the present state of tax law with respect to non-qualified deferred annuities.

The Service again relied on Revenue Ruling 77-85 and narrowed the issue to tax ownership of the assets wrapped in the annuity.[66] The ruling describes five annuity situations. In four of them, the Service argued that the policyholder is the true tax owner of the mutual fund and should be denied preferential tax deferral on income earned by the shares. In each of these four situations the mutual funds involved were available to the public. The only situation expressly escaping the Service's attack involved a single mutual fund managed by the insurance company that was not available to the general public.

Again, the Service relied on the argument that the policyholder in situations where the mutual fund the annuity invests in is available to the public is in the same position as an individual who purchases shares of a mutual fund directly. The Service stated that even though the policyholder does not manage the portfolio of the mutual fund, the shares of that fund, may be attributed to the policyholder. With regard to those shares, the Service stated that the policyholder has sufficient "incidents of ownership," even absent investment control, to be considered the tax owner.

Mutual funds available to the general public may no longer be the core of a variable annuity. The policy underlying this revenue ruling is easily discernible. The Service wishes to eliminate the disparate tax treatment of those who cloak investments in annuities, and those who invest directly. The Service is extending the policy that annuity tax treatment should be limited to funds set aside for retirement purposes, even though Congress rejected this policy in 1978.

By this series of revenue rulings, the methods by which a non-qualified deferred variable annuity may function and still qualify for favorable tax treatment have been drastically limited. The rulings are grounded upon logic contained in Revenue Ruling 77-85. Because of the inconclusive judicial activity generated by that ruling, the entire area is unsettled, and the tax issues presented by annuities need close reevaluation. The remainder of this article will focus on two key issues. First, whether the Service's position is correct. Second, a determination of the function annuities should perform in the future.

## AN ANALYSIS OF THE POSITIONS ASSERTED BY THE IRS IN REVENUE RULINGS 77-85, 80-274 & 81-225

### *Is Revenue Ruling 77-85 Correct?*

1. Statutory Problems.

The initial issue is whether an investment annuity fits the statutory

66. The focus was whether the insurance company would be taxed under the marginal rates while the policyholder is taxed under I.R.C. § 72 (1976), or if the policyholder should be taxed currently on income earned under I.R.C. § 61 (1976). Rev. Rul. 81-225.

definition of a variable annuity contract under section 801(g)(1)(a).[67] If the contract is not a variable annuity, then the reserve held with respect to that contract will not qualify as a life insurance reserve under section 801(b) and the issuer will not qualify as a life insurance company under section 801(a).[68] This would subject the company to normal corporate taxation rather than insurance company taxation. The tax on investment earnings would flow through to the policyholder in the form of increased premiums thus defeating tax deferral.

Section 801(g)(1)(A) expressly states that: "For the purposes of this part, an 'annuity contract' includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract." A key requirement of the statutory definition is the reference to the "[i]nvestment experience of the company issuing the contract." The regulations do not elaborate on this requirement except to state that: "A variable annuity differs from the ordinary or fixed annuity in that the annuity benefits payable under a variable annuity contract vary with the *insurance company's* investment experience."[69]

This language raises the issue of whether the statute requires that the insurance company actually *control* the investment of the policyholder's funds?[70] The legislative history of this provision does not clarify the issue.[71] The plain meaning of the phrase "insurance company's investment experience," however, lends weight to the argument that the phrase implies the issuer must control the investment. There is, however, a contrary position.

Arguably the term "insurance company's investment experience" means the investment experience of the company as a whole, whether or not a portion of that experience is generated by policyholders who control their accounts. The problem with using this language to determine whether an investment annuity qualifies as a variable annuity is that the language was enacted into law prior to the development of investment annuities.[72]

The district court, in *Investment Annuity, Inc.,* dealt with the "investment experience" language and concluded that the government's argument that Congress intended to grant only traditional variable annuities preferential tax treatment was "entirely unpersuasive."[73] The court held that, "[t]he mere fact that Congress did not consider an as yet uninvented alternative to a 'statutorily-approved' arrangement cannot be said to bar application of the statute to a later-invented alternative if the alternative is comparable to the

67. *See* I.R.C. § 801(g)(1)(B) (1976).

68. Treas. Reg. § 1.801-7(a)(2) (1962).

69. Treas. Reg. § 1.801-7(a)(1) (1962) (emphasis added).

70. This was the argument asserted by the government at the district court level in *Investment Annuity, Inc. v. Blumenthal. See* Memorandum in Support of Defendants' Opposition to Plaintiffs' Motion for Preliminary Injunction and in Support of Defendants' Motion to Dismiss at 33-34, *Investment Annuity, Inc.*. 442 F. Supp. 681 (D.D.C. 1977).

71. *See* S. REP. No. 2109, 87th Cong., 2d Sess. 7, *reprinted in* 1962 U.S. CODE CONG. & AD. NEWS 3890, 3896.

72. I.R.C. § 801(g)(1) (1961) was enacted in 1959.

73. 442 F. Supp. at 689.

'approved' arrangement in substantially all respects."[74] The court concluded that the "investment experience" language should not be read to preclude investment annuities from receiving preferred statutory treatment.[75] The district court correctly decided this issue, because the "investment experience" language is by no means dispositive of whether an investment annuity is a section 801(g)(1)(A) annuity.

The next major issue raised by the revenue ruling is who is the true tax owner of the assets wrapped in an investment annuity. Initially, the problem of whether judicial rules of tax ownership apply to this situation must be resolved. The issuer in *Investment Annuity, Inc.* argued that section 801(g) was intended by Congress to control the tax treatment of annuities. Thus, if the contract complied with the section 801(g)(1)(A) definition of an annuity, and the reserve qualified under the section 801(g)(1)(B) definition of a segregated asset account, then the income generated from the assets in that account should be taxable to the life insurance company under section 802. The insurer maintained that since Congress intended to include variable annuities in the insurance taxation scheme, section 801(g)(1) mandates taxation of income earned by the wrapped assets to the insurance company.[76]

A serious defect in the insurer's argument becomes clear when section 802 is considered. Section 802 imposes a tax on the taxable income *of* every life insurance company. In *Poe v. Seaborn,* the United States Supreme Court held that the term "net income *of* every individual" is synonomous with ownership.[77] Thus, the calculation of "insurance company taxable income" is intrinsically dependent on a finding of tax ownership.

The distinction between constructive receipt and tax ownership must be discussed. Determining tax ownership involves an examination of the true relation between the taxpayer and the wrapped investments. A finding that the policyholder is the true tax owner shifts the tax liability from the insurance company's preferential rates to the individual's rates under section 61. Constructive receipt is a different issue. Even if it is concluded that the insurance company is the tax owner of the wrapped investments, the income earned by those investments could be taxed to the individual in certain circumstances under constructive receipt notions.

2. Tax Ownership.

Courts have often announced that the rule that using substance rather than form in characterizing a transaction is "[p]articularly applicable to annuities and trusts because they are easily susceptible to manipulation so as to create an illusion."[78] The Supreme Court has emphasized that "[t]axation

74. *Id.*

75. *Id.*

76. Essentially, the issuer in *Investment Annuity, Inc.* argued that mortality factors involved in annuity contract liabilities, and reserve requirements imposed by those annuities, entitled the insurance company to taxation under the insurance provisions under Alinco Life Ins. Co. v. United States, 373 F.2d 336, 345-49 (Ct. Cl. 1967).

77. 282 U.S. 101, 109 (1930) (emphasis added).

78. La Fargue v. Commissioner, 73 T.C. 40, 53 (1979) (citing Lazarus v. Commissioner, 58 T.C. 854, 864 (1972), *aff'd,* 513 F.2d 824 (9th Cir. 1975)).

is not so much concerned with the refinements of title as it is with actual command over the property taxed. . . ."[79] These notions are applicable to investment annuities. The basic theory of tax ownership where there is a transfer of income producing property[80] is that there must be a "substantial change" in the transferor's control over the assets in order for tax ownership to transfer.[81] A corollary requirement is that there be a substantial change in the economic position of the transferor.[82] Both requirements are tested against the facts and financial reality of the situation at issue.[83]

In *Investment Annuity, Inc.*, the government asserted that two rights retained by the policyholder in an investment annuity contract were sufficient to conclude that the policyholder was the tax owner of the wrapped assets. The most significant was the power to control investment among the list of approved assets.[84] The other was the right to make total or partial withdrawals prior to annuitization.

The district court deemed retention of investment control insufficient to warrant the conclusion drawn in Revenue Ruling 77-85. The court compared the situation to the grantor-trust provisions.[85] Under these provisions, the income earned by trust assets is taxable to the trust even though the grantor retains investment control over the corpus, providing that the assets comprising the corpus do not consist of stock of a corporation in which the grantor has significant voting control.[86] The court thus concluded that investment control should not be significant in testing ownership.

The court failed to fully address the fact that the investment control sanctioned by the grantor-trust provisions is necessarily limited to the situation where the grantor may not revoke the trust for at least 10 years.[87] The investment annuity contract at issue contained both a partial and total cash surrender option prior to annuitization. Such an option serves to defeat the court's analogy to the grantor-trust provisions.

The court noted that the very nature of a cash surrender option limits the policyholder to receipt of money rather than the wrapped assets. The court asserted that since the policyholder forfeits the right to the assets, a significant incident of ownership is thereby divested.[88] For several reasons, this logic is patently incorrect.

First, the court did not mention that the original investment may have been cash, which is exactly what would be returned in a cash surrender situation. Second, the revocable transfer provision does not require that the

79. Corliss v. Bowers, 281 U.S. 376, 378 (1930).

80. For the purposes of this analysis money will be considered income producing property for the reason that it is readily converted into the income producing assets in an investment annuity account.

81. Helvering v. Clifford, 309 U.S. 331, 335 (1940).

82. *Id.* at 335-36.

83. *Id.* at 336.

84. *Investment Annuity, Inc.*, 442 F. Supp. at 685.

85. *See supra* note 2.

86. I.R.C. § 675 (1976).

87. I.R.C. § 673 (1976).

88. 442 F. Supp. at 690-91.

grantor revest himself in the assets; rather, the right to withdraw a cash amount from a trust following liquidation of the trust assets is a sufficient power of revocation.[89] Until annuitization occurs, therefore, the policyholder has a right equivalent to the prohibited power to revoke a trust. Accordingly, the district court's conclusion that an investment annuity contract would pass muster under grantor-trust provisions is in error.

The cash surrender option alone is not dispositive of the issue of tax ownership of the assets in an investment annuity account. Most deferred variable annuities contain cash surrender options.[90] A cash surrender option is only one power retained by the policyholder, and the Supreme Court in *Clifford* emphasized that the aggregate of retained controls is to be tested.[91]

In *Clifford,* the Supreme Court emphasized that tax ownership does not change if the transferor retains "[t]he substance of full enjoyment of all the rights which he previously had in the property."[92] Thus, if the policyholder is in a substantially identical economic position after the transfer as that which existed prior to the transfer, then that transfer should not be recognized for federal tax purposes. In *Investment Annuity, Inc.,* the government strongly urged that the annuitant's position had not significantly changed due to the aggregate impact of the retained controls. A major flaw in the district court's logic was that instead of applying this aggregate test, the court dealt with the retained controls on an individual basis. This approach is clearly contrary to the Supreme Court's test in *Clifford,* which looked to "[t]he aggregate" to determine whether the taxpayer retained a fair equivalent of his pre-transfer incidents of ownership.[93]

If the rights of an investment annuity policyholder are tested in the aggregate, the government's argument is more credible. Before the annuity is purchased, the taxpayer may possess funds which he is free to invest in any asset, whether productive or not. Further, upon purchase of the asset, the taxpayer is free to sell that asset and reinvest the funds. If the taxpayer purchases an investment annuity, the resultant economic position is almost identical. Under the terms of the policy, the taxpayer is free to select an investment in a broad variety of approved assets. Even if he wished to place the money in a non-approved asset, he could exercise the surrender option, pay a minimal fee, and receive the liquidation funds. Thus, in both situations the money is subject to the taxpayer's discretion. The fact that he cannot receive the account in kind does not substantially change the economic reality, since the assets will consist of intangible property useful only for income production to the taxpayer. Obviously, this function is not affected by whether the taxpayer directly possesses the indicia of ownership himself or possesses them indirectly through an annuity.

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89. *See* Coursey v. Commissioner, 33 B.T.A. 1068, 1070 (1936). *See also* Rev. Rul. 548, 1971-2 C.B. 250, 251.

90. Withdrawals from annuities are generally treated as return of original capital on a first in, first out basis. I.R.C. § 72(e)(1)(b) (1976).

91. *Clifford,* 309 U.S. at 336.

92. *Id.*

93. *Id.*

The only significant difference between annuity purchaser's position and that of a direct investor, is initial and subsequent loading charges charged to the annuity investor. Loading charges are completely earned by the company when paid; therefore a policyholder may never recoup these costs. The annuitant incurs these expenses in exchange for the right to annuity payments at a future date. If the policyholder exercises the cash surrender option, the right to annuity payments in the future is forfeited, and the policyholder cannot buy into another annuity without incurring additional loading charges. The district court concluded that this result indicates that the policyholder's economic position was substantially different from that of direct investment.[94] However, this conclusion is debatable.

The loading fee can be viewed as a payment for investment and retirement planning. So viewed, the charges are comparable to charges incurred for the advice of tax consultants and investment managers. Arguably, an investor who pays an annuity load charge is in the same position as an investor who obtains retirement or portfolio advice. Further, the load charge does not really affect the policyholder's position with relation to the assets in the account, and this relation is at the heart of the *Clifford* rationale. In *Investment Annuity, Inc.*, the government was correct in concluding that the policyholder's economic position had not substantially changed. The aggregate retained rights were simply too complete in the investment annuity contract to warrant a decision that ownership had shifted.

3. Constructive Receipt and the Investment Annuity.

In support of Revenue Ruling 77-85, the government argued that constructive receipt was applicable to income earned by assets wrapped by the investment annuity.[95] While the constructive receipt theory is a distinct alternative to tax ownership, it is overridden by Congress's decision to tax the insurer on income earned during the accumulation period at special rates if the insurance company is the tax owner of the wrapped assets.[96] Therefore, the constructive receipt doctrine must yield to the statutory provisions of insurance taxation if tax ownership is found to rest with the insurer.[97]

Because the policyholder of the investment annuity is the true tax owner of the wrapped assets, there is no statutory bar to the application of constructive receipt theory. The government argued in *Investment Annuity, Inc.* that constructive receipt was applicable to any income earned in an investment annuity.[98] Essentially, the government contended that because the policyholder

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94. *Investment Annuity, Inc.*, 442 F. Supp. at 690-91.

95. Brief for Appellant at 43, 48, *Investment Annuity, Inc.*, 442 F. Supp. 681 (D.D.C. 1971). This point was raised on appeal, but because the court of appeals reversed on procedural grounds, the issue was not addressed.

96. *See* I.R.C. § 802 (1976 & Supp. II 1978) (illustrating congressional intent to tax insurance companies on income earned by investments they own). When read in conjunction with I.R.C. § 72 (1976), which taxes the policyholder on annuitization, I.R.C. § 802 overrides the constructive receipt theory.

97. Bulova Watch Co. v. United States, 365 U.S. 753, 761 (1961).

98. Brief for Appellant at 43, 48, *Investment Annuity, Inc.*, 442 F. Supp. 681 (D.D.C. 1977).

had the right of partial cash surrender, he could remove an amount equal to the earned income annually and only be taxed when the aggregate withdrawals exceeded the original contribution.[99] Under the rules of constructive receipt, this income would be currently taxable because it was earned, set aside, and not subject to substantial limitations due to the lack of a significant withdrawal penalty. However, the policyholder might argue the inapplicability of constructive receipt based on the front loading charge. The argument is that each cash withdrawal represents an incremental decrease in the funds which will be available upon annuitization. Thus, the policyholder has reduced the insurance protection against insufficient retirement income, and forfeited the loading charge attributable to that amount.[100]

This argument breaks down if the loading charge is seen as attributable to amounts contributed to the policyholder's account rather than income earned by account assets. Absent a significant penalty for withdrawal, the policyholder should be deemed to be in constructive receipt of income earned. This conclusion is only possible, however, when the policyholder is the tax owner of the account assets, thereby rendering the statutory mandates of section 802 and section 72 inapplicable.[101]

*Revenue Rulings 80-274 and 81-225*

1. Tax Ownership.

The basic premise behind the Service's position in Revenue Rulings 80-274 and 81-225 was enunciated in *Helvering v. Clifford,* which based tax ownership on a finding that a taxpayer must be in a substantially different position after the transfer. This basic *Clifford* language, however, was extended in the annuity revenue rulings. The Service asserted that the policyholder's position must differ from what it would have been had he purchased the assets directly rather than through an annuity.[102] This extension seems to reflect a dual policy on the part of the IRS. First, the *Clifford* rule would be ineffectual if a taxpayer could satisfy the test of being in a different economic position by simply transferring cash into a trust, and ordering the trust to purchase a particular asset. The language of the case clearly indicates that the required change in position is measured against the "[b]undle of rights retained."[103] Thus, the Service correctly focused on the relative positions of the policyholder investing funds directly or indirectly through an annuity.

99. *See* I.R.C. § 72(e)(1)(B) (1976).

100. This argument has been cited as another rationale for the non-application of constructive receipt doctrines to annuities. *See* Caplin, *Taxing Tax-Deferred Annuities: A Critique of the 1978 Carter Proposal,* 1978 INS. L.J. 329, 332.

101. *See supra* note 96.

102. "Under the annuity contract, the policyholder's position is substantially identical to what the policyholder's position would have been had the investment been directly maintained or established with the savings and loan association." Rev. Rul. 274, 1980-2 C.B. 27, 28-29.

"The policyholders' position in each of these situations is substantially identical to what his or her position would have been had the mutual fund shares been purchased directly." Rev. Rul. 81-225, 1981-41 I.R.B. 20.

103. *Clifford,* 309 U.S. at 337.

The Service's reliance on the *Clifford* language to support its direct-versus-indirect investment distinction is also an extension of another policy. As evidenced by the 1978 proposal to deny favorable tax treatment to deferred annuities, the Service is attempting to restrict preferential tax treatment to annuities performing a retirement function. The IRS has acted to prohibit an annuitant with tax deferred treatment from having the same investment options as an investor who will invest directly and pay tax on income as earned. Both recent rulings support these policies.

In Revenue Ruling 80-274, the annuity was used to wrap interest earned by a certificate of deposit, or a mutual fund which was held in the depositor's account by the savings and loan association. The policyholder had both a partial and total cash surrender option up to annuitization. The Service asserted that the policyholder's position was substantially identical to what it would have been under a direct account with the savings and loan association.[104] Assuming that the particular contract does not require a loading charge greatly in excess of an investment counselor's fee, nor a substantial penalty for exercise of the surrender option, the Service's position is essentially correct. The fact that the annuitant's contract is with the insurer rather than the bank should be of no tax significance since the rights retained are ultimately the same as those of a direct depositor, even though exercisable only through the insurer.[105] In effect, the Service's position embodies the proposition that absence of investment control alone is insufficient to switch tax ownership. Rather, the focus is on the taxpayer's economic position in relation to the wrapped assets.

Essentially, the same analysis is applicable to the conclusions of Revenue Ruling 81-225; however, the issues are more complex. The Service again stated that the policyholder's position did not substantially differ from that of a direct investor in a mutual fund. This argument is obviously the core of the distinction between an annuity involving a mutual fund available to the general public and an annuity involving a mutual fund available only through the purchase of an annuity contract. The distinction has credence when considered in light of the logic of Revenue Rulings 77-85 and 80-274. The indirect purchase of mutual funds available to the general public creates a contact similar to an investment annuity. The fact that the policyholder owns the mutual fund shares indirectly is of no consequence since any mutual fund involves indirect ownership.

Revenue Ruling 81-225 stated that management of a mutual fund by an individual other than the taxpayer is inconsequential because the shares of the mutual fund themselves are the proper focal point of analysis.[106] This

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104. *See supra* note 102.

105. "[I]t makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency." Griffiths v. Commissioner, 308 U.S. 355, 357-58 (1939).

106. "Although a mutual fund's diversified portfolio of securities is controlled by the manager of the mutual fund and not by the policyholder, this does not distinguish these situations from Rev. Ruls. 77-85 and 80-274 because the mutual fund shares themselves

analysis appears correct since the taxpayer's economic position with respect to the mutual fund shares should be different under an annuity contract in order to avoid the *Clifford* rules. However, while investment control is one factor to be considered in determining tax ownership,[107] a change in economic position is required to shift tax ownership.[108]

Under the initial situation considered in Revenue Ruling 81-225, the issuer was allowed to switch mutual funds at its discretion. This is important since the policyholder's position is arguably dissimilar to a direct purchase of the particular mutual fund shares. The issuer, not the policyholder, is entitled to substitute mutual fund shares, so that the policyholder is not always guaranteed that his funds will be invested in the mutual fund originally selected. The policyholder of such an annuity might argue that substantial rights incident to ownership have thus been relinquished.

This argument is credible. The annuitant who purchases an annuity contract, as described in Revenue Ruling 81-225, has no guarantee that the mutual fund shares which formed his original account will remain in his account. By contrast, a direct investor is allowed to select and retain the mutual fund which is most compatible with his investment objectives and criteria.

The IRS has thus extended the sweep of Revenue Ruling 81-225 too far. The policyholder's economic position has surely changed when control over the annuity investment is relinquished. The Service is attacking all deferred variable annuities despite congressional intent to protect some of them.

## THE RESULT OF THE RULINGS: CHAOS

### *Immediate Issues: Implementation of Revenue Ruling 81-225*

The most pressing current issue is how to implement Revenue Ruling 81-225.[109] Although the Service stated that annuities may wrap mutual funds unavailable to the general public, no guidelines were set forth. The industry will probably respond by directing annuity investments to mutual funds that are slightly different than those available to the investing public. The critical question is how different must the contrived mutual funds be from those offered to the general public. Arguably, the entire effect of the ruling could be avoided by including some low risk, low yield investments in mutual funds

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are securities the incidents of ownership of which may be attributed to the policyholder in these situations." Rev. Rul. 81-225, 1981-41 I.R.B. 19, 20.

107. The *Clifford* Court looked to the aggregate impact of the retained control, five year reversion and the fact the income from the trust was to support the grantor's wife. 309 U.S. at 335.

108. *Id.* at 335-36.

109. Revenue Ruling 82-55, 1982-14 I.R.B. 6, recently issued to clarify Revenue Ruling 81-225, stated that policyholders may direct allocation of invested funds among various mutual funds if such funds are unavailable to the general public. The *Clifford* rationale so viewed as extending to particularized investment decisions and not selection of a "broad investment strategy." This distinction is logical since any policyholder can control the broad investment strategy by selecting an annuity wrapping a mutual fund that is compatible with his investment criteria.

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available only through annuities, yet allocating only a fraction of the overall investment to such funds. Alternatively, such funds could contain differing investments with identical expected returns. Where the Service will draw the line remains uncertain.

Another aspect of Revenue Ruling 81-225 is unclear. The ruling granted tax deferral to a non-public mutual fund managed by the insurance company. It is uncertain whether the ruling forbids insurance companies from shifting annuity investments from non-public mutual funds to public mutual funds.[110] Although the ruling does not expressly prohibit this, the IRS would probably argue that it does so implicitly.

Arguably, an insurer could still offer annuities that would wrap investments available to the general public and even allow investment control by short circuiting the tax ownership principles. An annuity could embody the major tax benefits of an investment annuity by providing for a large penalty upon withdrawal or simply negating the cash surrender option. Of course, such a contract would only be attractive to a taxpayer who truly desires to use the deferred annuity as supplemental retirement income, since the funds would be committed for the deferral period. However, this is a modest price for tax deferral on an investment revenue which the taxpayer may control.

## CONCLUSION

If the Service extends the logic of its distinction between mutual funds available to the general public, and those available only to annuitants, the next step may be a ruling prohibiting an annuity issuer from tying a segregated asset account to any particular investment or investment group. The Service may rule that only variable annuities tied into the issuer's general investment experience may avoid the *Clifford* rules. Such a ruling would be the Service's ultimate expression of opposition to annuities performing an investment function. Annuitants would be precluded from shopping for policies wrapping particularly attractive investments.

Congress should establish guidelines delineating the amount of control an annuitant may retain over wrapped investments. Just as *Clifford* triggered passage of the comprehensive grantor trust provisions, *Investment Annuity, Inc.* and the subsequent revenue rulings it fostered should trigger comprehensive annuity legislation.

GAIR PETRIE

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110. This was allowed in situation 5 of Rev. Rul. 81-225, 1981-41 I.R.B. 20 because the option was contained in situation 1 and situation 1 formed the basis of situation 5.