Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

Notice 2004–15

This notice provides guidance regarding when a distribution from a non-qualified annuity will satisfy § 72(q)(2)(D) and, therefore, be exempt from the penalty tax imposed by § 72(q)(1). Specifically, the Internal Revenue Service (IRS) and Treasury will treat a distribution as satisfying § 72(q)(2)(D) if the taxpayer uses one of the methods described in Notice 89–25, 1989–1 C.B. 662, as modified by Rev. Rul. 2002–62, 2002–2 C.B. 710, to determine whether the payment is part of a series of substantially equal periodic payments.

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Section 72 sets forth rules for the taxation of amounts received under an annuity contract. Section 72(q)(1) imposes a penalty tax on certain premature or early distributions under annuity contracts equal to ten percent of the amount that is includible in gross income. The penalty tax under § 72(q)(1) will not be imposed, however, if the distribution satisfies one of the exceptions set forth in § 72(q)(2). Section 72(q)(2)(D) provides that a distribution will not be subject to the penalty tax if it is "part of a series of substantially equal periodic payments (not less frequent than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary." If the payments are subsequently modified, § 72(q)(3) generally requires a taxpayer to take into account the penalty tax, plus interest, that would have been imposed if § 72(q)(2)(D) had not applied to the prior distributions.

Section 72(t)(1) imposes an additional tax on premature distributions from "qualified" annuity contracts (*e.g.*, a § 403(b) annuity contract or a § 408 individual retirement annuity) that is similar to the penalty tax imposed by § 72(q). Section 72(t)(2)(A)(iv) also provides that the additional tax does not apply to a series of substantially equal periodic payments and § 72(t)(4) sets forth a recapture rule similar to the rule of § 72(q)(3).

Notice 89–25 provides guidance regarding the imposition of the additional tax on distributions from qualified employee plans, § 403(b) annuity contracts, and individual retirement annuities (IRAs). Notice 89–25 sets forth three methods for determining whether payments to individuals from their IRAs or from their qualified retirement plans constitute a series of substantially equal periodic payments for purposes of § 72(t)(2)(A)(iv). The three methods are: (i) the required minimum distribution method; (ii) the fixed amortization method; and (iii) the fixed annuitization method.

Under the required minimum distribution method, the annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. *See* Rev. Rul. 2002–62 § 2.02(a) (life expectancy tables). With this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. If this method is chosen, no modification in the series of substantially equal periodic payments will be deemed to occur, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.

Under the fixed amortization method, the annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined by using the chosen life expectancy table and the chosen interest rate. *See* Rev. Rul. 2002–62 § 2.02(a) (interest rates). With this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

Under the fixed annuitization method, the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the taxpayer and beneficiary). The annuity factor is derived using the mortality table in Appendix B to Rev. Rul. 2002–62 and using the chosen interest rate. With this method, the account balance, the annuity factor, the chosen interest rate and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

Prior to 2002, Notice 89–25 provided that the additional § 72(t)(1) tax would be imposed if (i) at any time before attaining age 59½ a taxpayer changed the distribution method to a method that does not qualify for the exception, or (ii) the taxpayer changed the distribution method within 5 years after the receipt of the first payment. Rev. Rul. 2002–62 modified Notice 89–25 by providing two exceptions to this rule. First, an individual is not subject to the § 72(t)(1) additional tax if (i) the payments are not substantially equal because the assets in the individuals account plan or IRA are exhausted, and (ii) the individual followed one of the prescribed methods of determining whether payments are substantially equal periodic payments. See Rev. Rul. 2002–62 § 2.03(a). Second, an individual who begins receiving distributions in a year using either the fixed amortization or fixed annuitization method may switch to the minimum distribution method for the year of the switch, and all subsequent years, and the change will not be treated as a modification within the meaning of § 72(t)(4). Any subsequent change, however, will be a modification for purposes of § 72(t)(4). See Rev. Rul. 2002–62 § 2.03(b).

APPLICATION OF NOTICE 89–25, AS MODIFIED BY REV. RUL. 2002–62, TO SECTION 72(q)(2)(D).

The IRS and Treasury believe that, when the provisions of § 72 are intended to address different concerns with respect to the treatment of qualified and non-qualified annuities, it is appropriate to apply those provisions in a different manner. However, if the provisions of § 72 are designed to achieve the same purpose whether or not the annuity is qualified or non-qualified, it is appropriate to apply that provision in the same manner to both qualified and non-qualified annuities.

The current language of § 72(q)(2) derives from § 1123(b)(2) of the Tax Reform Act of 1986, Pub. L. No. 99–514, (the "1986 Act"). The legislative history relating to the 1986 Act's amendments to § 72 indicates that Congress intended that the additional income tax on early withdrawals should be the same for all tax-favored retirement savings arrangements and should be increased so that the additional tax serves, in most cases, to recapture a significant portion of the benefits of deferral of tax on income. See H. Rept. No. 99–426, 99th Cong. 1st Sess. 703–04 (1985), 1986–3 C.B. (vol. 2) 703–04; S. Rept. No. 99–313, 99th Cong. 2d Sess. 567 (1986), 1986–3 C.B. (vol. 3) 567.

The IRS and Treasury believe that because these provisions were enacted for the same purpose it is appropriate to apply the same methods to determine whether a distribution is part of a series of substantially equal periodic payments. Therefore, taxpayers may use one of the methods set forth in Notice 89–25, as modified by Rev. Rul. 2002–62, to determine whether a distribution from a non-qualified annuity contract is part of a series of substantially equal periodic payments under § 72(q)(2)(D).

DRAFTING INFORMATION

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