



GACs - Questions & Answers

1. What is a GAC?

A GAC is a Group Annuity Contract, designed in complete compliance with section 72 and section 817 of the Internal Revenue Code of 1986, as amended (the “Code”). A GAC can be either registered (i.e. with the SEC) or unregistered (i.e. a private placement).

2. What is a variable annuity contract?

A variable annuity contract is defined by section 817(d) of the Code to mean a contract where:

- (a) the assets are held in a separate account,
- (b) the amount paid out of the contract reflects the investment return and the market value of the assets in the separate account, and
- (c) the contract “provides for the payment of annuities”.

3. When does a variable annuity contract “provide for the payment of annuities”?

Where a variable annuity contract is a “pension plan contract”, it is automatically treated as providing for the payment of annuities (section 817(e) of the Code). A “pension plan contract” is broadly defined by section 818(a) of the Code to include contracts issued to essentially all types of qualified plans, governmental plans, and IRAs. Thus, GACs sold to pension plans would be treated as “pension plan contracts”.

Where a variable annuity contract is not a pension plan contract (i.e. it is issued to endowments or foundations), the variable annuity contract must:

- (a) have named “primary annuitants” to serve as measuring lives for the payment of annuity payments,
- (b) have named primary annuitants that are members of a professional group or an employee group,
- (c) have a sub-account established and maintained for each primary annuitant,
- (d) distribute the amounts in the sub-accounts within five (5) years of the death of a primary annuitant,
- (e) provide for the purchase of an immediate annuity for the primary annuitant and payout once the primary annuitant reaches age ninety (90), and

- (f) provide permanent annuity purchase rate guarantees for the purchase of immediate annuities (on the latter point, see Rev. Rul. 73-333 and Rev. Rul 72-139).

Thus, a GAC designed to be issued to pension plans does not need primary annuitants while a GAC designed to be issued to endowments and foundations does need primary annuitants.

4. Has the IRS ruled on whether a variable annuity issued to an endowment or a foundation is a “variable contract” for the purposes of section 817(d) of the Code?

Yes. The IRS has issued three private letter rulings (PLR 200206047, 200248021 and 9708022) that hold that variable annuity contracts issued to endowments and foundations would, under the facts of those rulings, be treated as variable contracts as that term is defined in section 817(d). Note that the published private letter rulings (“PLRs”) are only binding on the IRS for the party that received the ruling. Furthermore, the IRS will only issue a PLR on a specific case. Hence, absent a specific PLR, one can only take comfort knowing that the terms of the GAC are similar to those in the three published rulings.

5. Do GACs have the same diversification requirements (defined by section 817(h) of the Code) as other variable annuities?

The answer depends on whether or not the GAC is a “pension plan contract”.

Pursuant to section 817(h)(1), a “pension plan contract” does not have to be adequately diversified. If a GAC is sold to an endowment or a foundation, and, thus, is not a “pension plan contract”, the GAC is subject to the diversification requirements of section 817 and Reg. 1.817-5.

The general rules for diversification in the Regulations require that:

- No more than 55% of the value of the total assets in the separate account be represented by any one investment;
- No more than 70% of the value of the total assets in the separate account be represented by any two investments;

- No more than 80% of the value of the total assets in the separate account be represented by any three investments;
- No more than 90% of the value of the total assets in the separate account be represented by any four investments.

Separate accounts should be monitored and examined quarterly to ensure that they meet the diversification requirements of section 817 and Reg. 1.817-5.

6. Does section 72(u) apply to GACs?

Yes. Section 72(u)(1)(A) provides that an annuity contract that is held by a person who is not a natural person (e.g. a tax-exempt entity) will not be treated as an annuity contract for the purposes of determining the income of the owner of the annuity. Therefore, the insurance company issuing the GAC will provide to the tax-exempt entity information for determining the amount of income generated under the GAC each year.

7. What is UBTI?

Most all tax-exempt entities (pension plans, endowments and foundations) file informational tax returns, but the income shown is generally not subject to U.S. federal income tax (section 501(a) of the Code). Tax-exempt entities enjoy broad statutory exemptions from U.S. federal income tax on all sources of income other than income attributable to an unrelated trade or business (i.e. Unrelated Business Taxable Income” or “UBTI”).

UBTI is defined under section 512(a)(1) as income from a trade or business the conduct of which is not substantially related to the performance by the tax-exempt organization of the functions forming the basis for its exemption, and which is regularly carried on by the organization. Thus, the ownership of most debt-financed real estate and the shares of active businesses will probably create UBTI for tax-exempt entities.

8. What are the consequences of earning UBTI?

If a tax-exempt entity does earn UBTI, the tax-exempt entity is subject to income tax at full corporate rates on such UBTI (section 512(b)(1)). Many tax-exempt entities regard the realization of any reportable UBTI as increasing their audit exposure on other activities of the organization. Thus, tax-exempt entities try to avoid activities that may produce UBTI.

9. Are there types of taxable income that are excluded from UBTI?

Yes. Section 512(b) excludes from the definition of UBTI all dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, annuities, and most capital gains.

10. What is the “character” of income from a GAC that the tax-exempt entity must report each year?

It is generally believed that while the tax-exempt entity must accrue income on the annuity contract annually, such income should not be considered to be UBTI because:

(a) amounts credited to a variable annuity contract do not constitute UBTI because the investments in the separate account are owned by the life insurance company issuing the GAC, not a tax-exempt entity, and

(b) an investment in a variable annuity contract by a tax-exempt entity should not be considered a “trade or business”, as passive, investment-type activities are generally not intended by Congress to be treated as the conduct of a trade or business.

Tax-exempt entities must seek their own legal and tax advice regarding the character of income that the entity must accrue on an annual basis.

11. Naming of Primary Annuitants.

Upon purchasing a GAC, an endowment or foundation must name a group of primary annuitants, provide their ages, and allocate premium payments among sub-accounts established for each primary annuitant (each primary annuitant will have his/her own “Primary Annuitant Segment” as defined in the GAC).

These named primary annuitants are merely the measuring lives for purposes of determining the timing of annuity payments under the GAC but have no rights of distributions under the GAC until they reach the “Income Date” (e.g. attainment of age 90). All distributions before the Income Date are paid to the owner of the GAC: the endowment or foundation.

A sufficiently large number of primary annuitants should be named in order to minimize any disruption to the plans of the endowment or foundation in the event of the untimely death of a primary annuitant before the Income Date. Twenty is the minimum number. It is advisable to select individuals who are in good health and not too advanced in age, and with whom the endowment or foundation expects to have sufficient contact into the future so as to be aware of his/her death.

12. What is the Income Date?

The GAC for an endowment or foundation contemplates that a specific Income Date will be specified for each primary annuitant. Before the Income Date, the endowment or foundation may, but need not, purchase an annuity with the balance in the Primary Annuitant Segment of the primary annuitant.

Consideration should be given to setting the Income Date at, say, age 90 for each primary annuitant. This allows maximum flexibility to the endowment or foundation to keep Primary Annuitant Segments invested until age 90 of the primary annuitant (or until an annuity is purchased for the primary annuitant).

13. What happens if a primary annuitant dies prior to the Income Date?

Upon the death of a primary annuitant before the Income Date, the GAC for an endowment or foundation provides that the amount in the Primary Annuitant Segment for such primary annuitant must be paid to the endowment or foundation within five (5) years following the primary annuitant's death. During that five year period, any quarterly cash flow distributions under the GAC will be credited against any required distributions due to the death of a primary annuitant.

The insurance company issuing the GAC typically has the right to terminate the GAC unless the endowment or foundation names a substitute upon the death of a primary annuitant (in which case, the distribution of the amount in the Primary Annuitant Segment will be deemed to be paid to the endowment or foundation and recontributed to the GAC as new premium on behalf of the substitute primary annuitant). Thus, the new primary annuitant takes over the Primary Annuitant Segment of the deceased primary annuitant.

14. Can an endowment or foundation change a primary annuitant?

Under section 72(u) of the Code, a change in a primary annuitant is treated as the death of that primary annuitant. For this reason, an endowment or foundation cannot change a primary annuitant unless the endowment or foundation treats the Primary Annuitant Segment of the outgoing primary annuitant as distributed and establishes a new Primary Annuity Segment on behalf of a new primary annuitant, the balance of which equals the Primary Annuitant Segment of the replaced primary annuitant.

15. How can primary annuitants be chosen?

The law of the state where the GAC is issued will determine how a "group" can be defined. For example, in New York, primary annuitants must fall into either of two categories of persons associated with the endowment or foundation: employee groups or professional groups.

- **Employee Groups:** In New York, a GAC may be issued to an "employee group" of named primary annuitants. Thus, either all or just a class of an organization's employees may be named as primary annuitants in a GAC issued in New York.
- **Professional Groups:** In New York, a GAC may be issued to the trustees of an endowment or foundation which permits professional persons to become annuitants. For example:
 - i. A college with an endowment managed by trustees to fund research at the institution could name as primary annuitants a group of professors or other education professionals.
 - ii. An engineering association's charitable endowment managed by trustees could name a group of engineers, such as the association's officers and board members.

Again, the determination of how a “group” will be defined for a GAC will be based upon the law of the state where the GAC is issued.

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