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Session 065: Product Tax Hot Topics

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Product Tax Hot Topics Session 65

Toronto, Canada

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SOCIETY OF ACTUARIES

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Presenters

- Brian G. King, FSA, MAAA
Ernst & Young LLP
- Craig R. Springfield, Esq.
Davis & Harman LLP
- Ladelle Baar, CPA
London Life Insurance Company

Overview

- Part 1
 - Overview of Life Insurance Product Tax Considerations: U.S. v. Canada
- Part 2
 - Product Tax Update

Overview of Life Insurance Product Tax Considerations: U.S. v. Canada



What is the General Tax Treatment of Life Insurance for Policyholders?



Disclaimer

The tax rules governing life insurance in the US and Canada are complex, and vary based on contract issue dates. There are many factors that could potentially affect the policyholder tax treatment of a life insurance contract, include the type of owner (e.g., individual, corporation), the issue date relative to regulatory changes in the tax law, how the policy was acquired (original owner v. purchaser), the relationship between the owner and the insured, etc. The slides that follow provides some general thoughts around the relative policyholder tax treatment for an individual purchasers of a life insurance contract in the US and Canada and should not be relied on as providing tax advice.

Terminology

Concepts/Terminology	US	Canada
Tax qualified policy	Compliant	Exempt
Non-tax qualified policy	Failed	Non-exempt
Tax qualification test	Guideline premium test or Cash value accumulation	Exempt test
Purpose of qualification test	Limit the investment orientation of a life insurance contract	
Limitations imposed by tax qualification test	Cash surrender value and/or cumulative premiums paid	Accumulating fund
Pre-death payments of cash value	Distributions	Dispositions
General tax treatment of a qualified policy	Deferred recognition of income accrual for policyholder Death benefits not includable in income for beneficiary	

United States

- Life insurance contracts are generally classified as:
 - Contracts that qualify as life insurance under section 7702, further classified by section 7702A into two groups:
 - Modified endowment contracts, or MECs
 - Contracts that are not MECs, or Non-MECs
 - Contracts that do not qualify as life insurance under section 7702 (uncommon)
- Purpose of section 7702:
 - Limits investment orientation – distinguishes life insurance from investments
 - Defines maximum investment orientation in terms of allowable cash value and/or cumulative premiums for a given death benefit
- A contract's status under section 7702 and 7702A sets forth the policyholder tax treatment, which in turn sets for the insurance company tax information reporting and withholding obligations.

United States

- Tax treatment of death benefits
 - Section 101 exclusion from taxable income for amounts received under a life insurance contract by reason of the death of the insured
- Tax treatment of distributions
 - Non-MECs
 - Under section 72(e), withdrawals are treated first as nontaxable recoveries of “investment in the contract” to the extent thereof, and then as distributions of taxable income
 - Loans generally are respected as indebtedness and loan proceeds are not taxable
 - No 10% penalty tax on taxable distributions from a Non-MEC
 - Recapture rules
 - Income ordering rule reversed for certain force-out distributions
 - MECs
 - Under section 72(e), withdrawals are treated first as receipt of any income on the contract to the extent thereof, and then as returns of “investment in the contract”
 - Income on the contract equals cash value (without reduction for surrender charges or policy loans) over “investment in the contract”
 - Loans (and amounts assigned or pledged) are treated as amounts received
 - A 10% penalty tax applies subject to certain exceptions (such as where the taxpayer is over age 59½)
- Tax information reporting obligations for insurers
 - Income received under a life insurance contract generally is reportable by the insurer on Form 1099-R

Canada

- Life insurance contracts are generally classified as policies that qualify as a life insurance policy under Income Tax Act (ITA) section 148
 - Policies that meet the conditions of exempt policies under regulation 306 are tax exempt policies (non exempt policies are uncommon)
 - Majority of policies sold in Canada are designed to be tax exempt.
- Purpose of ITA section 148 and regulation 306:
 - Limits investment orientation – distinguish life insurance from investments
 - Limits amount of cash/account value that can be accumulated (build-up of investment income) in a policy relative to its death benefit
 - An exempt policy means the annual cash value growth inside the policy is not subject to annual accrual taxation (can accumulate on a tax-deferred basis).
 - It's primary purpose is providing insurance protection.
- If the life insurance policy is considered tax exempt according to regulation 306, this sets forth the policyholder tax treatment, which in turn sets for the insurance company tax information reporting for annual accrual gains and gain up to death.
 - Other tax reporting and withholding obligations do not change

Canada

- Tax treatment of distributions:
 - Depending on the life insurance product, the savings element may be used to surrender value, pay premiums, increase death benefit, or as collateral on a loan.
 - Full disposition:
 - Section 56(1)(j) requires income inclusion as a policy gain (if the proceeds of the disposition (POD) of the interest exceeds the adjusted cost basis (ACB)) from the disposition of an interest in a life insurance policy is included in taxable income for the year.
 - Partial disposition:
 - Under section 148(1) and 148(9), withdrawals are treated as a disposition or deemed disposition. Any proceeds of disposition above the ACB of the policy is considered a policy gain.
 - Only partial dispositions are required to prorate the ACB (using cash surrender value (CSV)), therefore there is no need for MEC definition which is used under the US tax rules.
 - Net Cost of Pure Insurance (NCPI) is a measure of the cost of insurance used for tax purposes (DB-NPR*Mortality factor). NCPI reduces the ACB of the policy (making the taxable gain higher).
 - The ACB is the amount you “paid in” for tax purposes. It is the portion of cash value that can be returned to a policyowner on an income tax-free basis when a withdrawal is made while the life insured is alive.
 - If a partial disposition is immediately used to repay a policy loan it is still a deemed disposition, but the repayment of the loan is the first impact to the ACB (increases the ACB) with the partial disposition second (decrease the ACB). This may impact the gain. Note that a repayment of the loan is eligible for a deduction up to the amount of any taxable gain created in the past.
 - Dividends, loans and transfers are also treated as deemed dispositions
 - The ACB is reduced by the amount of the disposition and increased by any gain. Generally, if the POD is greater than the ACB there will be a taxable gain. Interest on the loan may be taxable (depends on capitalization and deductibility).
 - However, if a dividend or loan is used as an internal transaction there may be no impact to ACB and therefore there may be an impact to the gain (if internal transaction is a premium payment need to consider premium definition).

Canada

- Tax treatment of death benefits:
 - Section 148(9) excludes from the definition of “disposition” a payment under the policy in consequence of the death from taxable income for amounts received under a life insurance contract by reason of the death of the insured.
 - Typically death claims paid to beneficiaries are not taxable for both exempt and non-exempt policies.
- Tax information reporting obligations for insurers:
 - If the POD exceeds the ACB at the time of a real or deemed disposition, then there is taxable income and it must be reported.
 - Income received under a life insurance policy generally is reportable by the insurer on a T5 slip as a policy gain, which is 100% taxable.

How is Qualification with the Tax Law Determined?



United States

- In order for life insurance companies to satisfy their tax information reporting obligations, they must know whether the contracts they have issued comply with sections 7702 and 7702A
 - As a practical matter, this places upon the insurer an obligation to ensure compliance with section 7702 and to be aware of whether a contract is a MEC
 - Insurers thus design and administer contracts to comply with section 7702; if errors under section 7702 are discovered, companies generally fix those problems through a proceeding with the IRS
 - Insurers generally maintain procedures to ensure that policyholders consent to a contract becoming a MEC
- IRS enforcement
- Other ways in which problems are discovered

Canada

The Exempt Test

- To be exempt from accrual taxation, the policy must meet a continuing test (done each policy anniversary) relating to the level and rate of growth of the savings element inside the policy (called the Accumulating Fund (AF) in the Income Tax Act).
 - The “Basic Test” compares the AF of the policy to the total of all exempt test policies (ETP) for the policy as defined in the Regulations of the Income Tax Act.
 - The latter is the AF of the ETP. It is a legislative test to determine if the policy has an accumulated fund higher than that what is allowed under the legislation.
- The exempt test has two sub-tests that are performed before the Basic Test in order to establish the issue dates for the ETPs.
 - They are the “8% Test” and the “250% Test”.
 - They are done first in order to get all the required ETPs along with their associated issue dates and death benefits.
- Different coverages can result from joint coverages or multi-life policies for example

Canada

Overview

- The tax legislation breaks policies into generations:
 - “G1” policies are those issued on or before December 1, 1982 and are not subject to tax exempt testing
 - “G2” policies are those issued between December 2, 1982 and December 31, 2016 and
 - “G3” policies are those issued on or after January 1, 2017
- There are 3 steps:
 - Step 1: 8% Test
 - Step 2: 250% Test
 - Step 3: Basic Test
- Failing step 3 will mean that the policy is non-exempt (other tests can contribute).
- The exempt test consists of testing that the AF of the actual policy is less than or equal to the AF for the ETP (a hypothetical policy) for the current anniversary and next anniversary.
 - The ETP for each coverage is based on the age, duration, death benefit determined in steps 1 and 2 and then sum them up.
- If not, than take action should be taken, otherwise the policy becomes non-exempt.

Canada

Regulation 307

- AF is a measure of the accumulated savings that have built up within the policy (savings element).
- AF is used for determining if a policy is exempt (compares savings accumulated within a coverage against tax legislation maximums) and in calculating taxable policy gains (accrual gains).
- AF is the greater of CSV (ignoring surrender charges and policy loans) and Net Premium Reserve (NPR).
 - NPR is a calculation defined in the legislation – fixed assumptions are prescribed regarding interest rates and mortality rates.
 - NPR represents the excess of PV of future benefits over the PV of future modified premiums + loans.

Overview of Tax Qualification Requirements for Life Insurance



United States

Tax Qualification Rules: In General

- Section 7702: Tax definition of “life insurance contract”
 - Must be life insurance under applicable law (e.g., state or foreign).
 - Must comply throughout the entire life of the contract with one of two actuarial tests:
 - The cash value accumulation test of section 7702(b); or
 - The guideline premium limitation and cash value corridor test of section 7702(c) and (d).
- Section 7702A: Tax definition of a MEC
 - MECs are life insurance contracts that constitute life insurance under section 7702 and which are considered more investment-oriented than other life insurance contracts.
 - Non-MECs are all other life insurance contracts.

United States

Section 7702: Definition of “Life Insurance Contract”

- Cash value accumulation test
 - In general. By the terms of the contract, the cash surrender value cannot exceed the net single premium required to fund future benefits under the contract at any point in time
 - “Terms of the contract” requirement
 - NSP calculation
 - Interest. Annual effective interest of 4% or, if greater, the rate or rates guaranteed on issuance of the contract (including short-term guarantees)
 - Reasonable mortality charges
 - No expenses, except certain expenses for qualified additional benefits
 - Computational rules, e.g., restricts ability to reflect increasing death benefits

United States

Section 7702: Definition of “Life Insurance Contract”

- Guideline premium limitation/cash value corridor test
 - Must meet both the guideline premium limitation (GPL) and the cash value corridor throughout the life of the contract
 - Under the GPL, premiums paid cannot exceed the greater of the guideline single premium (GSP) and sum of guideline level premium (GLPs)
 - Guideline premiums are calculated based on:
 - the higher of a statutory rate (6% for the GSP and 4% for the GLP) and any interest rate guarantees
 - reasonable mortality charges
 - reasonable expense charges
 - computational rules (maturity assumption age 95-100; level benefits subject to exceptions)
 - Adjustments to guideline premiums upon certain contract changes
 - Cash value corridor
 - The death benefit must be at least a prescribed percentage of cash value

United States

Section 7702A: Definition of “Modified Endowment Contract”

- General definition
 - A MEC is a life insurance contract within the meaning of section 7702 which is entered into on or after June 21, 1988 and either:
 - fails to meet the 7-pay test of section 7702A(b), or
 - was received in exchange for a MEC
- 7-pay test
 - A contract will fail the 7-pay test if the accumulated “amount paid” under the contract at any time during a 7-pay test period exceeds “the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums” (referred to herein as “7-pay premiums”).

United States

Section 7702A: Definition of “Modified Endowment Contract”

- 7-pay premiums
 - The 7-pay premium is a “net” level annual premium needed to pay up the contract in seven years
 - Interest. Annual effective interest of 4% or, if greater, the guaranteed rate or rates
 - Reasonable mortality charges
 - No expenses, except those reasonably expected to be imposed for QABs
 - Similar computational rules as under section 7702, except reductions in benefits outside of a 7-pay test period are disregarded
- Reduction in benefits rules
 - Upon reductions in benefits within a 7-pay test period (or at any time under second-to-die contracts), requires retroactive reapplication of the 7-pay test based on reduced benefits
- Material change rule
 - Starts a new 7-pay period if certain changes are made to a contract’s terms or benefits

Canada

8% Test: Details

- Annual increase in the death benefit (DB) coverage over 8% cannot be used to create additional sheltering capacity in that year. Any DB increase in excess of 108% of the total DB at the previous anniversary receives current dated ETP rates, which means lower tax room for that portion of the death benefit going forward.
 - Generally the higher the DB the more CSV permitted to accumulate on a tax-advantaged basis
- Other considerations:
 - AF will equal the DB by the time the life insured reaches age 90 (assuming no 8% failures past attained age 75)
 - The ETP factor is based on the issue age and duration of the policy and initially has a value of zero
 - All elements paid out as DB included in 8% test (life coverage face amounts, DB riders and any account value (Paid Up Addition (PUA) or Fund Value (FVB))
- Coverage vs. Policy level:
 - The policy AF is the maximum of the policy NPR (Net Premium Reserve) and the policy CSV. The policy NPR and policy CSV are calculated and compared at the policy level, not the coverage level.
 - The test applies separately to each life insured under the policy (the goal is to make multi-life policies the same as if a new separate policy was issued). Multi-life policies will have several ETPs. At the life group level, the test is restricted to life coverages and excludes FVB. Growth in DB equal or less than 8% is allocated to the ETP record with oldest declared date that correspond with life group coverages that have increased in DB. Excess allocated to new ETP with declared date of current anniversary corresponding to life group coverages/PUA that have increased DB.
 - At the policy level (includes FVB). Excess growth is allocated to new ETP record created with declared date of the anniversary being test. The FVB growth is allocated across life groups.

Canada

8% Test: Failure

- Impact of a Failure of the 8% Test
 - Step 1: DB on first ETP is increased up to 8%.
 - Step 2: If DB is more than 8% of DB at previous anniversary, a new ETP is deemed to be issued at the anniversary for the excess amount (essentially new policy issued for excess), which means less growth room.
- Impact to Basic Test:
 - Impacts the total death benefit used in calculating the AF and number of ETP lines in exempt test (for excess of DB over 8%).
- Other considerations:
 - The policy does NOT necessarily fail the anniversary exempt testing.
 - The new ETP line will have less accumulation or growth room because it is based on the issue date of the new ETP. The new ETP is treated as a new policy issue.

Canada

250% Test: Details

- Regulation 306(4)(b) of the Income Tax Regulations. It is an anti-dump-in provision that prevents overfunding of a policy, with little CSV in early years.
 - Limits the CSV growth within a policy in relation to deposit or premium history.
 - Limits large deposits or premium increases after 7th anniversary if there is not already a sizable AF built up
 - It is a comparison of the current AF of the policy to the AF of the policy from 3 years prior (3rd preceding anniversary, e.g., year 10 vs. year 7)
 - The 250% Test is done at the end of the 10th policy year and every year thereafter.
 - The policy fails the 250% Test if:
 1. The AF at current anniversary exceeds 250% of the AF on its 3rd preceding anniversary and
 2. The AF of the actual policy exceeds 3/8 of the AF of the ETPs issued

Other considerations:

- If ETPs are re-date, the policy will not need to be retested again until the following seventh policy anniversary.
- ETP initially has a value of zero.

Canada

250% Test: Failure

- Impact:

- If you fail the 250% Test, you will need to withdraw CSV or have the ETP's re-dated. If you fail the 250% Test and no corrective action is taken, you will be subject to annual accrual taxation.
- Funds removed from the policy (excess AF withdrawn to the limit – becomes new ETP for the policy).
 - This may create a taxable disposition.
- ETPs associated with the policy are re-dated to that 3rd preceding anniversary which limits the growth in the policy so that it would be similar to a policy issued 3 years ago.
 - The ETP lines of the policy are “reset” to that of a policy that is the same attained age but is at policy year 3 not year 10.

- Impact to Basic Test:

- Impacts Basic Test by changing age (current attained age) & duration, death benefit, and number of ETP lines.

Canada

The Basic Test

- The Basic Test is a comparison of the AF of the policy to the AF of the ETP.
- Exempt test is based on a defined benchmark policy using prescribed mortality and interest assumptions in an approximation to an 8-pay endowment paid at age 90 product design (a hypothetical policy).
- At the policy anniversary, the AF of the policy must be less than or equal to the AF for a hypothetical “exemption test policy”.
 - $AF(\text{policy}) \leq AF(\text{ETP})$

Are There Consequences of Not Meeting the Qualification Requirements?



United States

- Section 7702 failures
 - If a contract fails to comply with section 7702, income arising under the contract each year is currently taxable to the policyholder
 - Section 7702(g) defines income for this purpose (it includes gross-ups for cost of insurance and reductions in surrender charges)
 - The death benefit may be partially taxable
 - The Internal Revenue Service (IRS) procedures for addressing failures, e.g., Revenue Procedure 2008-40
- Section 7702A failures
 - An earlier slide described the tax treatment of MECs
 - But, what if the policyholder does not want a MEC and asserts that no consent to such status was provided?
 - State law question regarding the extent of insurer obligations to inform policyholders beforehand that premiums or other actions could result in MEC status and of steps that can be taken to reverse that treatment, e.g., through returns of premiums and interest thereon in some cases
 - IRS procedure for addressing failures, e.g., Revenue Procedure 2008-39

Canada

- Consequences of failing the exempt test are serious:
 - An exempt policy can become non-exempt in the future if it fails the exempt test at any anniversary (and is essentially considered non-exempt since issue).
 - Any gains that have accumulated in the policy at the time of becoming non-exempt will be taxable to the policy owner in the year in which this deemed disposition occurs.
 - Income earned in the policy after will be reported for taxation on an annual accrual basis (each future anniversary including death). The accrual gain is the difference between the AF and the ACB at the anniversary.
 - Lost exempt status cannot be regained
 - An exempt policy can become non-exempt in the future if it fails the exempt test at any anniversary, but fortunately, most insurance will contractually take the necessary steps to attempt to ensure that the policy remains exempt.

Canada

- Corrective action may be taken to ensure the policy continues to be tax exempt:
 - Surrender of account value or Paid-up Additions (PUA)
 - Automatic face increases (UL) or DB increased (within 8% limit)
 - Policy loan repayments by withdrawing CSV or dividends (lowers AF)
 - Adjust any excess premiums deposited or paid up premiums
 - 60-day window from time of failed test
 - After 60 days, if policy still non-exempt, then cannot regain exempt status

What are the Policyholder Tax Considerations of Owners Moving Between the US and Canada?



Is it Possible to Design a Product that Complies with Both the US and Canadian Tax Law Requirements?



Product Tax Hot Topics



Transition Issues for 2001 CSO Contracts



2017 CSO Mortality Tables

Background

- The 2017 Commissioners Standard Ordinary (CSO) mortality tables were approved for use for valuation and nonforfeiture purposes as a result of the adoption of the Valuation Manual (VM), having both a permitted and required date for use as follows:
 - Permitted date: January 1, 2017
 - Required date: January 1, 2020

2017 CSO Mortality Tables

IRS guidance: Notice 2016-63

- The adoption of a new mortality table has implications underlying section 7702 and 7702A calculations as the definition of “reasonable mortality” is based in part on the prevailing CSO mortality table as defined in new section 7702(f)(10) and as previously defined in section 807(d)(5)(A).
- Continuing with its long-standing practice of issuing safe harbor notices to address reasonable mortality requirements related to adoption of new mortality tables, the IRS issued Notice 2016-63:
 - Provides safe harbor rules for use of 1980, 2001 and 2017 CSO mortality tables
 - Provides effective date rules governing contract issue dates
 - Sets forth requirements for continued use of 1980 or 2001 CSO mortality tables following a policy change

Notice 2016-63

The 2001 CSO table safe harbor

A mortality charge with respect to a life insurance contract will satisfy the requirements of section 7702(c)(3)(B)(i) so long as:

- (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO tables;
- (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance;
- (3) either
 - (a) the contract is issued after December 31, 2008, or
 - (b) the contract is issued before January 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued; and
- (a) the contract is issued before January 1, 2020.

What is a contract's "issue date"?

- Guidance in Notice 2016-63
 - For purposes of this notice, the date on which a contract is issued generally is determined according to the standards that applied for purposes of the original effective date of section 7702.
- DEFRA BlueBook (page 655)
 - "... the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed."
 - "The use of a date on the policy would not be considered the date of issue if the period between the date of application and the date on which the policy actually placed in force is substantially longer than under the company's usual business practice." – Footnote 57

What is a contract's "issue date" (continued)?

- Satisfying the transition rules in VM 20 or the reasonable mortality requirements of section 7702 (e.g., through the safe harbor rules of Notice 2016-63) requires knowing a contract's "issue date."
- What role, if any, do the following items have on assigning an issue date to a contract?
 - Date of receipt of first premium
 - Date the application is signed
 - Date the underwriting process is completed
 - Date printed on the policy specification page
 - Length of backdating period
 - Date of receipt of section 1035 proceeds for an exchanged policy

Reporting Requirements for Life Settlements



Changes to U.S. Tax Rules for Life Settlements

- Reporting regime imposed by new section 6050Y
 - Reporting obligations for acquirers of life insurance contracts
 - Reportable policy sales (RPSs): Acquisitions of an interest in a life insurance contract, directly or indirectly (such as through a partnership or trust), if the acquirer has no other substantial family, business, or financial relationship with the insured
 - Reporting obligations for life insurance companies upon a RPS and upon transfers of a contract to foreign persons
 - Reporting obligation for life insurance companies upon payment of a reportable death benefit
 - Applicable to reportable policy sales after December 31, 2017 and to death benefits paid under contracts that were subject to a RPS
- Changes to transfer-for-value rule of section 101(a)(2) and (3)
 - These rules limit the excludable death benefit where there has been a transfer for value
 - The scope of exceptions to the transfer-for-value rule – where there is a carryover basis or certain related-party transactions – are limited where a contract was acquired in a RPS
- Proposed regulations have been issued by Treasury/IRS; IRS Forms 1099-LS and 1099-SB

Questions?