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ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS

On May 11, 2009, the Administration announced its Fiscal Year 2010 Revenue Proposals to raise revenue for health care reform. Among these are four proposals that directly affect the taxation of life insurance companies and products. The Administration included three of the proposals in a section entitled "Make reforms to close tax loopholes." The proposals would:

1. Expand the pro rata interest expense disallowance for corporate-owned life insurance (COLI) contracts;
2. Modify the dividends-received deduction (DRD) for life insurance company separate accounts; and
3. Modify rules that apply to sales of life insurance contracts.

The fourth proposal, included in a section entitled "Reduce the tax gap," would require information reporting on private separate accounts. The most recent revenue estimates by the Joint Committee on Taxation for these four proposals totals $11.7 billion over 10 years.[1]

1) Proposal to expand the pro rata interest disallowance for COLI, effective after the date of enactment.[2]

This proposal would disallow an interest deduction to a company to the extent of the cash value of its COLI policies on the lives of all except for 20-percent owners of the company or business, thus repealing the exception to the interest disallowance rule for COLI policies on the lives of individuals who are officers, directors or employees. The net impact of this proposal would be to eliminate the benefits of inside buildup on policies on the lives of officers, directors or employees. This proposal was previously considered and rejected in 1998. Since that time, Congress has addressed outstanding questions about broad-based COLI, and in 2006 imposed further conditions on the associated tax benefits.

The Administration's proposal increases taxes and restrictions on businesses that purchase life insurance. Businesses often purchase life insurance to protect against financial loss from the deaths of key employees and to facilitate business continuation after the death of a business owner. Many businesses purchase life insurance to fund the cost of employee and retirement benefits and to serve as a valuable risk-management tool. In 2006, Congress reformed the tax laws governing COLI to effectively limit coverage to highly-compensated employees or directors of a business and to require written and informed consent of the insured. No additional limitations are needed or appropriate.

2) Proposal to modify the DRD for life insurance company separate accounts, effective after Dec. 31, 2010.[3]

This proposal generally describes a change to the formula for measuring required interest, which is used to determine the company's share of the DRD. The tax code mitigates the double taxation of corporate earnings through the DRD. All corporate taxpayers are allowed the DRD, which generally provides corporate shareholders with a partial exclusion (70 percent) of the dividend amount from income tax. Life insurance companies have been subject to a set of rules that further limit the DRD for separate accounts for many years. The Administration's proposal is based on a misguided notion that life insurers' DRD under current law represents more than the insurers' interest in the dividends.

The separate account DRD is an integral element in an overall tax system that taxes life insurance companies. Life insurance companies' tax rules are part of a complex and well-reasoned mechanism based on sound tax policies that has worked well for many years. Indeed, life insurance companies pay material amounts of tax on variable annuity and variable life policies through deferred acquisition costs (DAC) and reductions in the reserve deduction. A legislative change that singles out one particular segment of that mechanism for review would be misguided and detrimental to this overall method of taxation.

The Administration's proposal would reduce life insurance companies' DRD by changing the calculations for DRD on separate accounts, which underlie variable life insurance and variable annuity contracts—important products for financial and retirement security.

The proposal is an inappropriate attempt to further reduce life insurers' DRD, thus increasing taxes and making variable life insurance and variable annuity products more expensive.

3) Proposal to modify rules that apply to sales of life insurance contracts, effective after Dec. 31, 2010.[4]

Most notably, this proposal would require anyone who purchases an interest in an existing life insurance contract with a death benefit equal to or greater than $1 million to report information on the sale to IRS, the insurance company and the seller. Upon payment of the death benefit under the affected policy, the proposal would require the insurer to issue an IRS Form 1099 to the payee.

The Administration's description provides little detail, but suggests that modifying the exceptions to the transfer-for-value rules in section 101(a)(2) to prevent the application of these exceptions to sales of life insurance policies.

4) Proposal to require information reporting on private separate accounts, effective after Dec. 31, 2010.[5]

This proposal would require life insurance companies to report to IRS, for each contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year, detailed information on the policy and the policyholder's financial interest in the account. The proposal defined a private separate account as any account with respect to which a related group of persons owned policies whose cash values, in the aggregate, represented at least 10 percent of the value of the separate account.

The Administration's description provides little detail, but suggests that increased reporting of investments in private separate accounts would help IRS prevent tax avoidance and to assist in the classification of variable insurance contracts as insurance contracts.

ACLI has actively opposed the proposals on COLI and DRD because the current rules are based on sound tax policy and should not be changed. We are exploring the implication of these proposals on our member companies and are seeking clarification on the proposals that require reporting on life settlement transactions and private separate accounts. The COLI and DRD proposals were characterized as "loopholes"—they represent long-standing rules and practices and are not loopholes. Moreover, changing the tax treatment of life insurers' COLI and DRD would make the products that provide financial and retirement security more expensive for families and businesses alike.

Defending the industry against inappropriate changes to the taxation of life insurance companies and their products remains a top priority for ACLI as the Administration and Congress work toward health care reform and possible tax reform amidst a continuing need for revenue in these challenging financial times.

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END NOTES

1. Joint Committee on Taxation (JCT), *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal* (June 11, 2009). The Office of Management & Budget's *Analytical Perspectives* of the Administration's FY 2010 Budget originally estimated these proposals at 12.7 billion over 10 years.
2. This proposal is estimated to raise $8.41 billion over 10 years. *JCT Estimated Budget Effects, supra* at note 1. The OMB's *Analytical Perspectives* originally estimated this proposal at $8.47 billion over 10 years. *Supra* at note 1.
3. This proposal is estimated to raise $2.63 billion over 10 years. *JCT Estimated Budget Effects, supra* at note 1. The OMB's *Analytical Perspectives* originally estimated this proposal at $3.44 billion over 10 years. *Supra* at note 1.
4. This proposal is estimated to raise $626 million over 10 years. *JCT Estimated Budget Effects, supra* at note 1. The OMB's *Analytical Perspectives* originally estimated this proposal at $812 million over 10 years. *Supra* at note 1.
5. This proposal is estimated to raise less than $500,000 over 10 years. *JCT Estimated Budget Effects, supra* at note 1. The OMB's *Analytical Perspectives* originally estimated this proposal at $20 million over 10 years. *Supra* at note 1.