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IRS RULES AGAIN ON CONTINGENT DEFERRED ANNUITIES

By John T. Adney and Bryan W. Keene

In private letter rulings 201105004 and 201105005, each dated Nov. 2, 2010 and released to the public on Feb. 4, 2011, the Internal Revenue Service (IRS) has again addressed the federal income tax treatment of insurance arrangements sometimes referred to as "stand-alone withdrawal benefits" or "contingent deferred annuities." Under such an arrangement, a certificate under a group insurance contract provides guaranteed minimum withdrawal benefits that are linked to an investment account that the certificate owner establishes with a financial institution. The facts of the two new rulings are the same, although the taxpayers and some of the issues addressed differ as between the two. Specifically, PLR 201105004 was issued to an individual taxpayer and dealt with issues pertinent to the certificate owner under the group contract, while PLR 201105005 was issued to an insurance company and addressed company-level issues, some of which overlap with the certificate owner-level issues.

Facts of the Rulings

The facts of the new rulings are similar to private letter rulings the IRS previously had issued on similar products. *See* PLRs 201001016, 200949007 and 200949036, which were discussed in an article published in *Taxing Times* in May 2010.[1] In general, the group contract is to be issued to an entity, labeled the "Sponsor" in the rulings, that offers investment advisory services to individuals and others, including with respect to "Managed Accounts" that the Sponsor advises. Unlike the case with the previous rulings, in which the sponsoring entity was not affiliated with the insurer issuing the contract, the Sponsor in the new rulings is a wholly-owned subsidiary of the issuer.

The group contract authorizes the Sponsor to sell contract certificates to certain individuals who own Managed Accounts with the Sponsor, subject to a periodic fee payable to the insurance company. The individual certificate holder can select some or all of the assets held in his or her Managed Account to be "Specified Assets" associated with the certificate—establishing a linked investment "Account." The Sponsor will then manage that Account in accordance with a specific investment objective identified in the certificate, and the Account owner will be subject to limitations on changing the investment strategy.

After a certain date identified in his or her certificate, each year the owner may withdraw an amount from the Account up to an "Annual Withdrawal Amount" (or "AWA"). The AWA is set, at issuance of the certificate, as the lesser of a specified dollar amount or a specified percentage of the Account value, and over a designated time period the AWA may increase via a "ratchet" or "roll-up" feature. The benefit provided under the certificate is that if the value of the Account is reduced to zero for any reason other than withdrawals or transfers exceeding the AWA, the insurer is obligated to provide the owner with a series of periodic payments equal to the AWA for the remainder of the owner's life.

Individual Tax Issues

In PLR 201105004, the IRS issued the following rulings with respect to the individual certificate owner:

(1) the certificate is an "annuity contract" within the meaning of section 72;[2]

(2) the certificate will not affect the individual's "holding period" with respect to the assets in the Account for purposes of determining whether such assets provide "qualified dividend income" within the meaning of section 1(h)(11), because the certificate does not diminish the individual's risk of loss on Account assets;

(3) the certificate will not affect the individual's ability to deduct investment losses in the Account under section 165(a), because it will not create a right to reimbursement for such losses; and

(4) the certificate and the Account assets will not be

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viewed as components of a "straddle" within the meaning of section 1092.

These rulings are similar to the ones issued in PLRs 201001016 and 200949007 and are discussed in more detail in the prior *Taxing Times* article. In addition, the new PLR covered three issues not addressed in the previous PLRs:

- *Amounts received as an annuity.* First, the IRS ruled that if the insurer becomes liable to pay the guaranteed minimum benefits under the certificate, those payments will be "amounts received as an annuity" under section 72(a). The IRS reached this conclusion based on its holding, noted above, that the certificate is an annuity contract within the meaning of section 72, observing in the ruling letter that the amounts payable under the contract met the definition of "amounts received as an annuity" under the section 72 regulations. This conclusion was implicit in the earlier PLRs involving similar products, in that the analysis of whether those products constituted annuity contracts noted that the withdrawal benefits met the definition of annuity payments in the section 72 regulations. The new PLR, however, made this conclusion an explicit holding, at the taxpayer's request.

- *Investment in the contract and adjusted basis.* Second, the IRS held that the periodic fee payable to the insurer under the certificate will be taken into account in determining the individual's "investment in the contract" for section 72 purposes as well as in determining the adjusted basis in the certificate under section 1011. In reaching its conclusion, the IRS cited to sections 72(c)(1) and 72(e)(6), each of which provides that for purposes of determining a contract's "investment in the contract," the aggregate amount of premiums or other consideration paid for a contract must be taken into account. It also cited to section 1011(a), which specifies that the adjusted basis of property (for determining the gain or loss from the sale or other disposition of the property) is its basis as determined under section 1012 or other applicable sections (typically the property's cost) and as adjusted under section 1016. The taxpayer's need for the holding on adjusted basis is not clear from the face of the PLR, but presumably it was connected with the fact, as recorded in the PLR, that the individual's interest in the certificate was transferrable.

- *Short sales.* Third, the IRS addressed the certificate's treatment under section 1233. That section provides rules as to the tax consequences of a "short sale" of property if gain or loss from the short sale is considered a gain or loss from the sale or exchange of a capital asset and the taxpayer holds substantially identical property. The IRS ruled that the certificate is neither a short sale of, nor an option to sell, the Account assets, rendering the provisions of section 1233(b) inapplicable.

Insurance Company Tax Issues

In the PLR issued to the insurance company (PLR 201105005), the IRS ruled, as it had to the individual taxpayer, that the certificate is an annuity contract within the meaning of section 72. This is the same ruling issued to the insurer in PLR 200949036, discussed in the prior *Taxing Times* article. The IRS also ruled to the insurer, for the reasons previously described and comparably to the rulings issued to the individual taxpayer, that (1) any guaranteed minimum benefits the insurer becomes obligated to pay will be treated as "amounts received as an annuity" under section 72(a), and (2) the periodic fee payable to the insurer will be taken into account in determining the certificate owner's "investment in the contract" under section 72 and his or her adjusted basis under section 1011. (These issues were not addressed in PLR 200949036.)

In addition, the insurer asked for, and the IRS issued, rulings on two other matters not addressed in the earlier PLRs. First, the IRS held that because the certificate is an annuity contract under section 72, the insurer will not be subject to the "mark-to-market" rules of section 475, based on the "life insurance products" exception to those rules in Treas. Reg. section 1.475(c)-1(d). Second, the IRS ruled that the periodic fee will be included in the insurer's gross income under section 803(a)(1) because of the certificate's treatment as an annuity contract.

Conclusion

Following a long struggle over determining the proper income tax treatment of contingent deferred annuities, both at the individual certificate holder level and at the insurance company level, it now appears that taxpayers and the IRS have come to a basic agreement on that treatment. The fact that more PLRs on this topic are appearing in the public domain demonstrates the solidifying of the IRS's views on the treatment of the product along with a rising interest in the product itself among insurers, mutual funds and others.

END NOTES

1 *See* Joseph F. McKeever, III, and Bryan W. Keene, "IRS Confirms Annuity Status of 'Contingent Annuity Contracts'," *Taxing Times*, vol. 6, issue 2 (May 2010).
2 Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended.

IRS APPROVES WELLNESS BENEFITS IN QUALIFIED LONG-TERM CARE CONTRACTS

By John T. Adney and Craig R. Springfield

Under IRC section 7702B(b)(1)(A), a qualified long-term care ("LTC") insurance contract is an insurance contract under which "the only insurance protection provided … is coverage of qualified long-term care services." If such a contract meets the requirements for treatment as "qualified" for section 7702B purposes, including the requirement just quoted, the benefits provided under the contract receive favorable income tax treatment. This treatment includes, for example, the characterization of the LTC benefits as accident and health insurance excludable from gross income and, in certain circumstances, the deductibility of the premiums under IRC section 213. In two identical rulings issued on Nov. 5, 2010, private letter rulings 201105026 and 201105027, the Internal Revenue Service (IRS) addressed the section 7702B treatment of a "wellness rider" proposed to be issued with or added to so-called stand-alone qualified LTC contracts.

According to these rulings, which were released to the public on Feb. 4, 2011, the wellness rider provides the insured with access to certain information regarding health, wellness and LTC for a dual purpose: "to either facilitate the provision of long-term care services or reduce the incidence or severity of any future need" for LTC. Some versions of the wellness rider also include a voluntary incentive program under which insureds who participate in periodic health assessments and meet certain health standards will be eligible for any premium discounts or benefit increases under their LTC contracts declared by the insurer. The rider is provided by the insurer at no stated additional charge to the policyholder.

The taxpayers that sought the rulings, which were the life insurance companies that issue the LTC contracts and proposed to issue the wellness riders, asked the IRS to rule on two issues arising from inclusion of the rider in an LTC contract. In the first requested ruling, the IRS was asked to hold that issuing the contract with the rider (under either version) would not cause the contract to be treated as providing coverage other than of qualified LTC services. A holding to this effect was essential to the insurers involved, for the reason that section 7702B(b)(1)(A) requires, as quoted above, that qualified LTC contracts provide coverage "only" of qualified LTC services, *i.e.*, any other coverage would preclude the contract from being "qualified" for purposes of section 7702B(a). The second requested ruling was that all of the premiums paid for a contract that includes the rider will be premiums for a qualified LTC contract. This was important to provide assurance, for example, that the entirety of the premiums would be eligible for deductibility under section 213.

In the rulings, the IRS reached favorable conclusions on both issues. With respect to the first issue, the IRS reasoned that the wellness rider, in and of itself, did not provide insurance coverage at all, and so it could not be providing insurance coverage of other than qualified LTC services. As the IRS observed, "[t]he information and incentives provided by the [wellness rider] are not insurance benefits but are a loss prevention program consistent with the purpose" of section 7702B. Thus, the ruling went on, "[i]t would be inconsistent with the stated goal of section 7702B to deny qualification to a long-term care insurance contract because it provided ancillary mechanisms aimed at minimizing long-term care needs." That "stated goal," according to the ruling, was the congressional purpose in enacting section 7702B, *i.e.*, to provide an incentive for individuals to take financial responsibility for their long-term care needs. As to the second issue, for much the same reason as it gave for its holding on the first issue, the IRS held that all of the premiums paid for the contract, regardless of the presence of the wellness rider, would be premiums for a qualified LTC contract. Specifically, the IRS said it saw no reason to recharacterize any contract consideration that could be allocated to the wellness program as other than amounts paid for an LTC contract.

In PLRs 201105026 and 201105027, the IRS took a very reasonable approach to interpreting the restriction in section 7702B(b)(1)(A) that limits qualified LTC contracts to providing "only" the insurance coverage of qualified LTC services. While the two rulings addressed wellness riders to be issued with or added to stand-alone qualified LTC

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contracts, the same reasoning and conclusions presumably would apply to permit similar wellness benefits to be provided in connection with the newer forms of qualified LTC coverages, namely, combination LTC-annuity and LTC-life insurance contracts.

REACTIVATING THE ACTIVE FINANCING EXCEPTION

By Kevin T. Leftwich and Biruta P. Kelly

Insurance companies with controlled foreign corporations ("CFCs") were breathing a temporary sigh of relief with the passage of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the "Extenders Bill") in December. Among the impressive list of tax provisions in the Extenders Bill is a short section amending I.R.C. §§ 953(e)(10) and 954(h)(9),[1] which extended the exceptions from Subpart F income for active financing income (the "Active Financing Exception") through tax years beginning before Jan. 1, 2012. Why were companies anxiously awaiting this extension? Because the Active Financing Exception had already expired for all tax years beginning after Dec. 31, 2009, and these companies were on the verge of seeing a potentially significant increase in their Subpart F income.

Foreign income earned by a foreign corporation attributable to a foreign business generally is not taxed in the United States until the income is distributed by the foreign corporation through payment of a dividend to a U.S. taxpayer. However, deferral of taxation is not permitted for Subpart F income earned by a CFC.[2] The goal of the Subpart F rules is to deter taxpayers from using related foreign companies "to accumulate earnings that could have been accumulated just as easily in the United States."[3] The Subpart F rules generally result in the owners of a CFC who are U.S. shareholders being taxed by the United States currently on their pro-rata share of the CFC's Subpart F income. Subpart F income includes "insurance income."[4] Additionally, Subpart F income includes foreign base company income, which includes foreign personal holding company income.[5] Foreign personal holding company income is any income derived from dividends, interest, rents, annuities, certain gain from sale of property, gain from foreign currency transactions, income from notional principal contracts, and amounts received under personal service contracts.[6] So, under the general rule, a significant amount of insurance companies' income earned through CFCs could be at risk of qualifying as Subpart F income.

This result is inappropriate to the extent the income originates from the core active insurance business activities of the CFCs—these are not earnings that "could have been accumulated just as easily in the United States." The Active Financing Exception was created to correct this result by exempting from current inclusion in taxable income certain income derived from so-called "active financing" activities. I.R.C. §§ 953(e) and 954(i) provide for the application of the Active Financing Exception to insurance companies, and exclude from Subpart F insurance income certain "exempt insurance income" and exclude from personal holding company income "qualified insurance income of a qualifying insurance company."[7]

The Active Financing Exception initially was added to the Internal Revenue Code in the Taxpayer Relief Act of 1997[8] as a temporary exception starting with tax years beginning in 1998. The temporary exception was extended, with modifications, five times by Congress between 1997 and 2008. Prior to the passage of the Extenders Bill, as mentioned above, the Active Financing Exception had expired for all tax years beginning after Dec. 31, 2009.[9] This expiration would have resulted in I.R.C. § 953(a) applying to CFCs in the same way it did prior to 1998. While the result is not certain, the Internal Revenue Service's position likely would be that underwriting income earned by the CFC related to insuring risk located outside of its country of origin and most investment income qualifies as Subpart F income. The adverse impact of this result could be magnified due to a rule that causes all the income of a CFC to be treated as foreign base company income, and thus Subpart F income, if the sum of the CFC's foreign base company income and insurance income for a taxable year exceeds 70 percent of total gross income.[10]

Applying the "old" law may not have been as simple as one would hope. Prior to the creation of the Active Financing Exception, the Treasury Department (Treasury) published Proposed Regulations §§ 1.953-0 through 1.953-7. The proposed regulations provided guidance, among other things, on determining when insurance income is earned in or outside of the CFC's country of origin, computing and allocating insurance reserves, and computing and allocating investment income. The proposed regulations generally were criticized by taxpayers in comment letters, and numerous meetings were held by the insurance industry with the Treasury. The industry thought that revised regulations would be issued, but they were never finalized, presumably in part due to the passage of the Active Financing Exception. It is unclear whether Treasury would have readdressed and finalized the proposed regulations if the Active Financing Exception had not been extended.

If the Active Financing Exception were to lapse, it not only would eliminate the benefit of deferral, it also would add an extra layer of complexity in calculating taxes associated with international activity of insurance companies, as there are a number of issues that would need to be resolved: (1) how do you determine whether insurance income is earned outside the country of origin, (2) how are reserves computed, (3) how is investment income calculated and allocated, (4) how are expenses allocated, (5) will the new rules require changes in method of accounting, and, perhaps most importantly, (6) will the proposed regulations be revised or finalized in the current form? While the Extenders Bill provided a reprieve from the need to address these issues, it is only a temporary one. Without another extension, it will be less than a year before the Active Financing Exception expires again for calendar year CFCs.

END NOTES

1 Section 750 of Extenders Bill.
2 I.R.C. § 951(a). A CFC is generally any foreign corporation that is owned more than 50 percent by U.S. shareholders. I.R.C. § 957(a). However, for purposes of applying the rules regarding Subpart F insurance income discussed below, the ownership threshold is reduced to 25 percent. I.R.C. § 957(b). For most situations, U.S. shareholder is defined as a U.S. person that owns at least 10 percent of the voting power of the stock of the foreign corporation. I.R.C. §951(b).
3 Koehring Co. v. U.S., 583 F.2d 313, 317 (7th Cir. 1978).
4 I.R.C. § 952(a)(1). I.R.C. § 953(a)(1) defines "insurance income" as "any income which – (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would [...] be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company."
5 I.R.C. § 954(a).
6 I.R.C. § 954(c).
7 *See* I.R.C. § 953(e)(1)(A) (defining "exempt insurance income"); I.R.C. § 953(e)(3) (defining "qualifying insurance company"); and I.R.C. § 954(i)(2) (defining "qualified insurance income").
8 Pub. L. No. 105-34.
9 I.R.C. §§ 953(e)(10) and 954(h)(9).
10 I.R.C. § 954(b)(3)(B).

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