SOCIETY OF ACTUARIES Taxation Section

IRS Confirms Annuity Status of "Contingent Annuity Contracts"

By Bryan W. Keene and Joseph F. McKeever, III

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In recent months, the Internal Revenue Service (the "Service") has released three private letter rulings addressing the tax treatment of group insurance contracts providing guaranteed minimum withdrawal benefits linked to an investment account (the "Account") that the owner establishes with a financial institution unrelated to the contract issuer.[1] The new rulings are the first to address the recent innovation of "unbundled" annuity products that strip the annuity to its core insurance elements. Such contracts have sometimes been referred to colloquially as "stand alone withdrawal benefits" or "contingent annuity contracts." Two of the rulings were issued to individuals who proposed to purchase certificates under the contracts,[2] and one of the rulings was issued to a life insurance company as the proposed issuer of the contract.[3]

The new rulings address four specific federal income tax issues with respect to the contracts. First, all three rulings conclude that the contracts will be treated as annuity contracts under section 72.[4] In addition, the rulings issued to contract owners address three questions that are pertinent to the owners' (but not the insurers') tax returns. Specifically, they conclude that the contracts: 1) will not affect the owners' ability to deduct losses incurred in the Accounts; 2) will not affect the owners' ability to receive "qualified dividend income" from assets in the Accounts; and 3) will not constitute part of a "straddle" with the Accounts.

The contracts involved in these rulings represent a significant departure from the typical annuity contract available to consumers, and, with the Service confirming their favorable tax treatment, the products have the potential to change the annuity landscape as it has existed in recent years. Both the typical deferred variable annuity contract with a guaranteed lifetime

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FROM THE EDITOR
NEW EDITORIAL BOARD

By Brian G. King

Welcome readers to another issue of *TAXING TIMES*. This issue looks at a variety of topics including recent guidance on longevity products, tax implications under the Defense of Marriage Act, and lingering effects of 2009 required minimum distributions under section 401(a)(9). Hopefully, you find these topics timely and the articles addressing them interesting.

Balancing the fast moving world of insurance tax with our *TAXING TIMES* publication schedule is a constant challenge for the Taxation Section Council. We try to get the information to our members in as timely a manner as possible. To this end, we are willing to add supplemental issues of *TAXING TIMES*, webinars and blast e-mails to our regularly slated issues and activities in order to keep our membership informed. Coming up on the horizon, the Obama Administration's proposed budget for fiscal year 2011 includes several insurance related initiatives, discussed further in the ACLI Update Column in this issue. We will monitor these proposals along with other insurance tax activities and report back to our members.

Of course, the flagship of our communication efforts remains our newsletter. The Taxation Section is committed to making *TAXING TIMES* a quality publication and to date, we have had success in this area. In our efforts to continue to challenge ourselves to maintain our high publishing standards, we have recently restructured the *TAXING TIMES* editorial board. Specifically, the decision was made by the Taxation Section Council to increase the size of our editorial board while at the same time introduce term limits for editorial board members. Term limits will allow existing members to roll off after serving their term and new members to join the board. In addition, a larger board will offer a broader perspective to the editorial process.

The editorial board serves several roles for *TAXING TIMES*. They discuss the content of upcoming issues, focusing on current tax topics, and seeking a balance between company and product tax. In addition, the editorial board provides the first line of the peer review process, determining if articles are appropriate, timely, technically sound and well written. Finally, editorial board members play a role in soliciting authors to write articles for *TAXING TIMES*. The new modifications to our editorial board structure will give the board a fresher perspective and broader expertise in fulfilling these responsibilities.

For this issue of *TAXING TIMES*, the "old dream team" editorial board consisting of myself, Peter Winslow (Scribner, Hall & Thompson, LLP), Frederic Gelfond (Deloitte) and Bruce Schobel (NYLIC) were joined by our new members – Daniel Stringham (Prudential), Arthur Schneider (AEGON) and Kory Olsen (Pacific Life). The new expanded dream team worked extremely well together for this issue and we saw improvements in our editorial process as a result of this expanded knowledge base. I would like to thank Dan, Art and Kory for agreeing to come on board, and officially welcome them. I would also like to thank our entire editorial board for their commitment to *TAXING TIMES*. Without their efforts, this would not be the quality publication that it is today.

Enjoy the issue!

NOTE FROM THE EDITOR

All of the articles that appear in *TAXING TIMES* are peer reviewed by our Editorial Board and Section Council members. These members represent a cross-functional team of professionals from the accounting, legal and actuarial disciplines. This peer-review process is a critical ingredient in maintaining and enhancing the quality and credibility of our section newsletter.

While this newsletter strives to provide accurate and authoritative information in the content of its articles, it does not constitute tax, legal or other advice from the publisher. It is recommended that professional services be retained for such advice. The publisher assumes no responsibility with assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation.

Citations are required and found in our published articles, and follow standard protocol. ◀

—Brian G. King

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FROM THE CHAIR

By Christian DesRochers

While the origins of the phrase "may you live in interesting times" is subject to some debate, there is little debate that those of us involved in the taxation of life insurance companies and products are living in interesting times, and will be for the foreseeable future. On the product side, last year saw private letter rulings released on annuity and long-term care combination products, longevity insurance and mutual fund living benefits. The Department of the Treasury (Treasury) 2009-2010 Priority Guidance Plan includes product-related issues including partial exchanges and partial annuitization of annuity contracts, the age 100 issue under section 7702, and annuity and long-term care combination products under sections 72 and 7702B. As we have in past even-numbered years, we will once again present the Product Tax Seminar on September 13 and 14 in Washington, D.C. This is an opportunity to hear speakers from industry and government talk about emerging life and annuity product tax issues. Unlike past years, however, we will be presenting the "Boot Camp" introductory topics as a series of webinars over the summer months leading up to the meeting. We hope that this will let us reach a wider audience, as well as generate additional interest in attendance at the seminar.

The dominant tax topic for 2010 is likely to be the emergence of principle-based reserves (PBR) and its implications for life insurance company taxation. The treatment of life insurance reserves has always been a significant element in the federal income taxation of life insurance companies. First, the amount of life insurance reserves determines if an insurance company is taxed as a life insurance company. Second, they are used to identify reserves that are required to be recomputed for tax purposes under the specific rules set forth in section 807(d). As long as premiums are treated as income, reserves will continue to be a key element in the determination of taxable income. Although the tax rules applicable to life insurance companies have gone through significant changes over the years, it has been a fundamental concept that a life insurer should not be taxed on income that is set aside to meet future contingent benefit liabilities. This is not changed by the introduction of PBR; however, the very elements that make PBR appealing—including the reliance on actuarial judgment and the use of more sophisticated financial modeling tools—create challenges in a tax valuation system.

Actuarial Guideline 43 (AG 43), effective for year-end 2009 for variable annuity contracts issued in 1981 and later, replaces Actuarial Guidelines 34 and 39, applicable to variable annuity minimum death benefits and living benefits, respectively. AG 43, or VACARVM as it was previously known, has been the subject of extensive discussions between the Treasury, the Internal Revenue Service (IRS) and the life insurance industry. Interim guidance, which should have been released before this edition went to print, is a first attempt to deal with the issues raised by the AG 43 valuation method. Tax issues related to the development of VACARVM, and the emergence of PBR have already been the topic of several articles in previous issues of *TAXING TIMES*. Now that companies have "gone live" with AG 43, we can expect that discussions will continue as the Treasury, IRS and taxpayers gain additional perspective on the effects of AG 43. We will continue to address the topic through *TAXING TIMES*, as well as webinar programs to provide our members with the insights on the emerging issues.

The Taxation Section is committed to providing both high quality and timely programming during the year. We provide speakers and programs for a number of Society of Actuaries' meetings and assist in reviewing educational materials. We also hope to gain additional insights into the needs of our

members through periodic surveys. However, *TAXING TIMES* remains our principal way of communicating with our members. In his column, Brian King discussed the expansion of the editorial board. Watching the effort that goes into each issue, I am very appreciative of the dedication of the many authors who provide content, as well as Brian, Christine and the editorial board for their hard work in developing the final product.

I hope to see many of our readers at programs throughout the year. We always welcome new volunteers, so if you have an interest in a program, or writing an article, please let me know. ◂

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withdrawal benefit ("GLWB") and the contracts addressed in the rulings offer annuitants the guarantee of a lifetime income in the event a pool of assets is depleted. However, the former provide the owner with the ability to defer taxes on increases in the cash surrender value, require the owner to cede control over the investments upon which the annuity payments depend to the insurer, and pay tax at ordinary income rates when gains in those assets are distributed from the contract. In contrast, according to the recent rulings, the new types of annuity contracts they address do not provide the benefit of tax deferral, but give the owner substantially more control over the assets upon which the annuity payments depend as well as access to capital gains tax rates with respect to sales and exchanges of those assets, which generally are lower than ordinary income tax rates.[5] These differences can provide valuable alternatives for consumers searching for effective ways to accumulate assets for retirement while also assuring themselves a guaranteed lifetime income. The new rulings, and the contracts they address, are summarized below.

FACTS OF THE RULINGS

The facts of the first two rulings, PLRs 200949036 and 200949007, which were released in December 2009, are identical, and the two rulings apparently involve the same contract. The facts of the third ruling, PLR 201001016, which was released in January of this year, are almost identical to those of the two earlier rulings. As a result, the rulings will be discussed together except where a difference between the 2009 rulings and the 2010 ruling is significant.

These differences can provide valuable alternatives for consumers searching for effective ways to accumulate assets for retirement while also assuring themselves a guaranteed lifetime income.

In the rulings, a life insurance company (the "Company") intends to issue a "Group Contract" to an unrelated financial institution (a "Sponsor"). The Group Contract will authorize the Sponsor to sell certificates (each, a "Certificate") to individuals who open an investment Account with the Sponsor. The life insurance company taxpayer intends to issue the Group Contract and Certificates, and the individual taxpayers intend to purchase a Certificate from the Company and establish an Account with a Sponsor.

Each Account can hold only shares of regulated investment companies (mutual funds) or other publicly-traded securities that the Company approves as being consistent with an investment strategy that the Company prescribes. The Company also specifies the maximum amount that an individual can invest in the Account. The Certificate has no cash surrender value. The Certificate involved in the 2009 rulings cannot be assigned or transferred, while the Certificate involved in the 2010 ruling can be assigned with the Company's consent.

Each Certificate obligates the Company to provide the owner with a series of periodic payments (the "Monthly Benefit") for the remainder of the owner's life if the Account balance is reduced to zero for any reason other than the Certificate owner withdrawing more than a prescribed annual amount (the "Annual Withdrawal") from the Account. Thus, the Certificate operates in much the same way that a guaranteed minimum withdrawal benefit operates under a deferred variable annuity contract, except that the assets that normally would comprise the "cash value" of the deferred annuity are held by the Sponsor, rather than the insurer, and the Certificate owner owns those assets for federal income tax purposes.

The Monthly Benefit and Annual Withdrawal amount are determined by reference to a "Benefit Base." On the Certificate date, the Benefit Base equals the Account value, and thereafter is increased for additional permitted cash investments in the Account. In the case of the 2009 rulings, depending on the terms of the individual's Certificate, the Benefit Base also may be adjusted upward on each Certificate anniversary to: 1) the Account value on that anniversary or a prior anniversary; 2) a minimum value specified in the Certificate; or 3) an amount determined by applying an annual cost of living adjustment to the Benefit Base. In other words, the Certificates described in those rulings offered both a "ratchet" and a "roll-up" benefit. In the case of PLR 201001016, the Certificate offered only a ratchet feature.

The Certificates involved in the 2009 rulings allow the owner to commence Annual Withdrawals from the Account at any time, while the Certificate involved in the 2010 ruling allows the owner to do so any time after a defined "Commencement Date." The amount of the permitted Annual Withdrawal is recalculated on each Certificate anniversary. This amount may increase, but will not decrease unless the owner takes withdrawals in excess of the then-applicable Annual Withdrawal amount ("Excess Withdrawals"). Such Excess Withdrawals will reduce the Benefit Base, the Annual Withdrawal amount

and the Monthly Benefit. The Certificate will terminate upon the owner's death, a stated maturity date,[6] the failure to pay charges, the termination of the Account, any investment by the Account in unapproved instruments, or any Excess Withdrawal that reduces the Account value to zero. The Certificate also provides the owner with the right to apply the Account value to purchase a life annuity ("Annuitized Payments").[7]

In all three rulings, the taxpayers represented to the Service that: 1) the Company will not have direct or indirect control over investment decisions with respect to the Account, although it may require automatic rebalancing of the Account to bring it into accord with the prescribed investment strategy; 2) the Sponsor will not be related to the Company; 3) the Account's holdings will not be limited to mutual funds that the Company or its affiliates manage; 4) the Company will not impose any significant barriers to reallocations among eligible assets within the Account; and 5) the Company will not have access to any nonpublic information about mutual funds in which the Account may be invested. In PLR 200949036, the Company also represented that it will issue the Group Contract only in states that treat it as an annuity contract, and in PLRs 200949007 and 201001016 the individual taxpayers represented that they will purchase the Certificate only if the regulations of the taxpayer's state of residence treat it as an annuity contract.[8]

Finally, the taxpayers in all the rulings provided the Service with an actuarial analysis of the contract, which concluded that the arrangement is substantially more sensitive to the risk of the owner's longevity than to volatility in the securities markets, and that the predominant risk "insured" against is longevity risk, with incidental market risk protection.

ANALYSIS AND CONCLUSIONS OF THE RULINGS

The rulings address four specific federal income tax issues with respect to the Certificates. First, all three rulings conclude that the Certificates will be treated as annuity contracts under section 72. In addition, the two rulings issued to Certificate owners (PLRs 200949007 and 201001016) address three questions that are pertinent to the owners' (but not the insurers') tax returns. Specifically, they conclude that the Certificates: 1) will not affect the owners' ability to deduct losses incurred in the Accounts; 2) will not affect the owners' ability to receive "qualified dividend income" from assets in the Accounts; and 3) will not constitute part of a "straddle" with the Accounts.

The Certificates are Annuity Contracts

As indicated previously, all three rulings conclude that the Certificates will be treated as annuity contracts for purposes of section 72. This treatment is important to both the issuer and the purchaser of the Certificate. For the issuer, among other things, it clarifies the Company's reserve deductions and tax reporting and withholding obligations with respect to the Certificates. For the purchaser, it means that the Monthly Benefit and any Annuitized Payments will be eligible for "exclusion ratio" treatment under section 72(b).[9] In concluding that the Certificates will be annuity contracts, the rulings also state that the purchaser (rather than the Company) will own the Account assets for tax purposes—with the necessary implications that the Account will not be part of the Certificates for tax purposes and that the Certificate owner will be currently taxable at capital gains rates with respect to sales and exchanges of Account assets.

With respect to the conclusion that the Certificates will be annuity contracts, the rulings observe that the Code does not provide a comprehensive definition of an annuity. As a result, the rulings focus on the various requirements applicable to annuities under the Treasury Department (the "Treasury") regulations, as well as on descriptions of annuities set forth in the legislative history of section 72, case law and several secondary sources.

Regarding the Treasury regulations, the rulings first note that Treas. Reg. section 1.72-2(a)(1) provides that the types of contracts governed by section 72 include those "which are considered to be … annuity contracts in accordance with the customary practice of life insurance companies." Perhaps prompted by this reference to customary practices, the rulings then discuss a number of sources describing key characteristics of annuity contracts and assess whether the Certificates possess a sufficient number of those characteristics to be properly viewed as annuity contracts for tax purposes.

For example, the rulings state that the Certificates possess two of the key characteristics of annuity contracts described in the legislative history of section 72(e), in that each Certificate represents "a promise by the life insurance company to pay the beneficiary a given sum for a specified period" and is "used to provide long-term income security."[10] The rulings also conclude that the Certificates have a "determining characteristic" of annuities described in the American Jurisprudence treatise on annuities, in that "the annuitant has an interest only in the periodic payments and not in any principal fund or source

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The rulings are clear, however, that while the Certificates are annuity contracts, the assets held in the Account are not part of those annuity contracts, and instead are owned by the Certificate holder for federal income tax purposes.

from which they may be derived."[11] Citing the same source, the rulings state that the Certificate owner will have "surrender[ed] all rights to the money paid," thereby distinguishing the Certificate from "installment payments of a debt, or payments of interest on a debt," which multiple authorities indicate are not annuities.[12] Finally, the rulings conclude that the Certificates satisfy the requirements of the Treasury regulations applicable to annuity contracts and annuity payments,[13] and that the Certificates are not merely contracts to pay interest within the meaning of Treas. Reg. section 1.72-14(a).[14]

In considering the determining characteristics of annuity contracts, the rulings also downplay the importance of two features of the Certificates that are somewhat unusual in comparison to other deferred annuity contracts available in the marketplace today. Specifically, the rulings note that the Certificates: 1) do not provide a cash surrender value; and 2) condition the availability of periodic payments on the Account value being depleted. These features are atypical of deferred annuities sold today, which generally provide cash values (and, in fact, promote the deferral of income tax on such values as a key attribute) and allow the owner to annuitize those values at any time. (Of course, the preponderance of deferred variable annuities sold today contain a GLWB that operates in much the same manner as item 2), but with reference to the contract's cash value.) The Service ultimately concluded that these somewhat unusual features of the Certificates are not dispositive of their treatment as annuity contracts in light of the many other characteristics of annuities that they possess.

We understand that the tax implications of the first of the foregoing two Certificate features (lack of cash value) was the subject of much internal debate at the Service, with some individuals at the Service expressing the view that a contract cannot constitute an annuity contract for federal income tax purposes if it does not provide a cash surrender value. It is not clear why this concern arose, especially with respect to the Certificates involved in these rulings, since the interest and earnings that accrue in the Account are currently taxable—in contrast to the tax deferral otherwise afforded to the cash surrender value of a deferred annuity contract.[15] In any event, the Service appears to have gotten comfortable that the presence or lack of a cash value is not dispositive. The Service had reached a similar conclusion in another private letter ruling issued earlier in 2009, where it cited several sources describing the existence of deferred annuities without cash values in the first half of the 20th century as indicating that such products are within the "customary practice of life insurance companies."[16] Consistently with that earlier ruling, the three more recent rulings point to a leading insurance treatise as indicating that the availability of a cash value during the accumulation phase of a deferred annuity is a function of state law,[17] with the necessary implication that some states allow deferred annuities that lack cash values and therefore it is a customary practice. All of the foregoing contributed to the Service apparently placing little relevance on the presence or lack of a cash value, and the rulings ultimately conclude that, on balance, the Certificates possess the essential attributes of annuity contracts. The rulings are clear, however, that while the Certificates are annuity contracts, the assets held in the Account are not part of those annuity contracts, and instead are owned by the Certificate holder for federal income tax purposes.

The Certificates Will Not Affect the Owners' Ability to Deduct Losses in the Accounts

The two rulings issued to Certificate owners also address the owners' ability to claim tax deductions with respect to losses incurred in the Account. In that regard, the Code generally allows individuals to claim a deduction for losses incurred in any transaction entered into for profit.[18] Because the Certificate owners will purchase, sell, or exchange assets in the Accounts with the goal of making a profit, they generally will be entitled to deduct losses they incur in connection with such activity. The owner could experience such investment losses if he or she sells or exchanges Account assets at a price that is lower than the owner's adjusted basis in the assets.

The Code, however, also places certain restrictions on a taxpayer's ability to claim loss deductions. In particular, a loss is not deductible if the taxpayer receives compensation for the loss through "insurance or otherwise."[19] Thus, if the individual has a reasonable prospect of recovering the loss through a claim for reimbursement, he or she cannot deduct the loss until it can be ascertained with reasonable certainty whether or not

the reimbursement will be received.[20] The two rulings issued to Certificate owners state that this determination is one of fact based on all the relevant facts and circumstances. They cite to a number of cases addressing whether losses sustained by a taxpayer were reimbursed by "insurance or otherwise," and ultimately conclude that the Certificates do not provide such protection against losses in the Account.[21]

In reaching this conclusion, the rulings state that the relationship between any individual market loss in the Account and any eventual periodic payments under the Certificate is too tenuous and too contingent on a number of factors for the periodic payments to be considered compensation for any given market loss. In this respect, the rulings state that "the fact, amount, and timing of the Monthly Benefit are contingent on a number of factors, including not only a particular market loss, but also other market losses, offsetting market gains, Taxpayer's withdrawal rate, and—most significantly—Taxpayer's life span." Although not specifically referenced in the rulings' analysis, the Service undoubtedly placed great emphasis on the findings of the actuarial analysis that the taxpayers submitted with their requests for rulings. As described above, that analysis concluded that the arrangement is substantially more sensitive to the risk of longevity than to the volatility of the securities markets, and that the predominant risk that the Certificates mitigate is longevity risk, with only incidental market risk protection. In other words, the taxpayers were able to demonstrate to the Service that the economics of the arrangements are more akin to a traditional annuity contract than protection against investment losses. As a result, the rulings conclude that the Certificate will not create a right to reimbursement for losses realized on Account assets for purposes of the rules governing loss deductions, and therefore will not prevent the owner from currently deducting such losses to the extent they are otherwise deductible.

In stating this, however, the Service cautioned that its conclusion was "based on and limited to the particular contract at issue, and the effect of that contract as represented by Taxpayer; it would not necessarily apply to a similar feature if the terms of the contract were significantly altered." This, too, suggests that the Service placed great weight on the taxpayers' actuarial analysis of the particular Certificates involved, as the Service went out of its way to add this caveat to the conclusion despite the fact that the law is clear that a private letter ruling will not apply to a transaction if the facts are materially altered.[22] Perhaps this caveat was the Service's way of ensuring that the taxpayers understood the actuarial analysis to be a material fact.

The Certificates Will Not Prevent Account Assets from Providing Qualified Dividend Income

The rulings issued to Certificate owners also address the treatment of certain dividends paid with respect to stock that the Account holds. Because the Certificate owners will own the Account assets for tax purposes, the owners will be currently taxable on any income that those assets generate—including any dividends paid by corporations that have issued stock that the Account holds. As a general matter, if a corporation pays a dividend out of its earnings and profits, the amount received by its shareholders is taxable, as either net capital gain or ordinary income. Capital gains rates apply only if the dividends constitute "qualified dividend income" ("QDI").[23]

QDI generally includes dividends received from domestic and, in some cases, foreign corporations.[24] To be eligible for capital gain treatment, the shareholder must hold the dividend-paying stock for a minimum time period (a "holding period"). The holding period is suspended— meaning that the taxpayer is treated as not holding the stock during the suspension—for any period in which the taxpayer has "diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property."[25]

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The relevant rulings conclude that a Certificate does not diminish the owner's risk of loss on Account assets under the foregoing rules. This means that the Certificate will not affect the owner's ability to receive QDI with respect to stock held in the Account, and that capital gains rates will be available with respect to dividends that otherwise constitute QDI. In reaching this conclusion, the rulings note, among other things, that the Certificate is not "substantially similar or related property" to the Account because: 1) the fair market value ("FMV") of the Account and the Certificate do not reflect the performance of a single firm or enterprise, the same industry or industries, or the same economic factors; and 2) changes in the FMV of the Account are not reasonably expected to approximate, directly or inversely, changes in the FMV of the Certificate.[26] As further evidence that the Certificate and Account are not substantially similar or related property, the rulings point out that longevity risk is the predominant risk for which the Certificates provide protection. Here, too, the taxpayers' actuarial analysis of the types of risks mitigated by the Certificates apparently weighed heavily in the Service's analysis.

The Certificates Will Not Form Part of a Straddle with the Accounts

The final question addressed by the two rulings issued to Certificate owners is the treatment of the Certificate and the Account under the tax rules applicable to "straddles." The term straddle as used in the Code has a somewhat different meaning compared to its common usage in the financial markets. In the latter context, the term generally refers to an options strategy in which the investor holds a position in both a call and a put with the same strike price and expiration date, such that the two positions exactly offset each other. In tax parlance, a straddle is more broadly defined as "offsetting positions" in actively traded personal property, with offsetting positions encompassing more than those that exactly offset each other.[27]

Straddles have a variety of nontax uses, including to lock-in gain from an appreciated position or to protect against market losses. In the past, however, straddles also were widely used solely to manipulate the timing of gains and losses (including manufacturing tax losses where no real economic loss occurred), or to convert ordinary income or short-term capital gain to long-term capital gain. In light of these abuses, Congress enacted section 1092 and related measures that generally allow nontax-motivated uses of straddles while preventing their use to manipulate the tax laws.[28]

In that regard, section 1092 imposes special rules that effectively suspend losses with respect to investment positions that are held as part of a straddle. If investments comprise part of a straddle, a loss incurred with respect to one of the investments cannot be taken into account in computing the taxpayer's gross income until that loss exceeds any unrecognized gain in the offsetting position. Under these rules, positions are "offsetting" if they result in a substantial diminution of the taxpayer's risk of loss—even if the positions do not exactly offset one another. Applied to the Certificates described in the rulings, if the Account and the Certificate were found to be offsetting positions that formed a straddle, presumably the owner would be precluded from reflecting on his or her tax return any loss incurred on the sale or exchange of Account assets until such time that the loss exceeded the excess of the owner's tax basis in the Certificate over its FMV, determined at the close of the taxable year.[29]

The two rulings issued to Certificate owners conclude that section 1092 does not apply to the Certificate and the Account, *i.e.*, that they do not form a straddle. The rulings note that the Certificate is not an "offsetting position" with respect to the Account, but offer no reasoning for reaching this conclusion. Presumably, the same reasoning outlined above in connection with the QDI issue supports the conclusion that the rulings reach under the straddle rules. In other words, the relationship between any individual market loss in the Account and any eventual periodic payments under the Certificate is too tenuous and too contingent on a number of factors—most importantly the owner's longevity—for the periodic payments to be considered "offsetting" with respect to any given market loss. Again, the taxpayers' actuarial analysis of the Certificates may well have proved critical to the Service's conclusions here.

OBSERVATIONS

As indicated earlier, the new rulings are the first to address the recent innovation of "unbundled" annuity products that strip the annuity to its core insurance elements. Such products intentionally disavow the benefit of tax-deferred inside build-up in exchange for access to more favorable capital gains tax rates while retaining the key longevity insurance protection that annuities traditionally provide. The rulings address the primary tax issues raised by this new product innovation and provide taxpayers with clear guidance as to their tax treatment. As with all private letter rulings, however, only the taxpayers to whom they were issued can rely upon them.[30] Moreover, the weight that the Service appears to have placed on the tax-

payers' actuarial analysis of the Certificates—demonstrating that the arrangements were "substantially more sensitive to the risk of longevity than [to] volatility in the securities markets"—strongly suggests that the Service might reach different conclusions if the facts were materially altered. As a result, perhaps more than usual, taxpayers who are contemplating similar products may wish to seek their own private letter rulings from the Service.

In addition, while the rulings clarify the primary tax issues relating to the Certificates, there are two related aspects of the rulings that leave the authors somewhat confused as to the Service's analysis of the Certificates' tax treatment. First, the rulings correctly note that the Certificate owners are treated as the owners of the Account assets for tax purposes, but in doing so they cite two examples from the Service's line of "investor control" revenue rulings as requiring that result.[31] In our view, the investor control doctrine is a specific application of the more general judicial principal of "substance over form."[32] In that regard, the doctrine has been applied to annuity products that, in form, place legal title of the underlying assets in the issuing life insurance company, but in substance give the policyholder so much command over those assets that he or she is properly deemed to own (and be currently taxed on) them for tax purposes.

The application of this doctrine to the arrangements described in the recent private letter rulings seems misplaced and unnecessary. Presumably, legal title in the Account assets resides with the Certificate owner, not the issuing life insurance company, so the form of the arrangement is already consistent with treating the individual as owning the Account assets for tax purposes. That form need not be disregarded using a substance over form analysis in order to reach the conclusion that the individual owns the assets. Moreover, the investor control doctrine is generally directed at disallowing the tax benefits normally afforded to annuity contracts (namely, tax-deferred inside buildup) in situations where the Service believes that the individual is more appropriately treated as directly owning the underlying assets. Again, such a goal is moot in the context of the Certificates addressed in the recent private letter rulings, as the taxpayers have already structured the arrangement so that the individual will be currently taxable on any income or gains generated in the Account.

A similarly confusing aspect of the recent rulings is the importance they appear to place on the lack of any corporate affiliation between the issuer of the Certificates and the Sponsor of the Accounts. Among the representations the Service appears to have required of the taxpayers were: 1) the Sponsor will not be related to the issuing Company; 2) the universe of investments that the Account will be permitted to hold will not be limited to regulated investment companies ("RICs") managed by the Company or its affiliates; and 3) the Company will not have any nonpublic information about the RICs in which the Account may be invested.

While not discussed in the analysis set forth in the rulings, these representations give the impression that the Service was struggling with whether the arrangements should be treated as annuity contracts in their entirety, with the assets in the Accounts being deemed to be owned by the Certificate issuer and therefore benefitting from the tax deferral that assets underlying deferred annuities otherwise enjoy. If that were the case, however, then surely the degree of the Certificate owner's control over those assets would result in the investor control doctrine applying to undo what the Service had just done, thereby redeeming the assets as being owned by the individual, and not the carrier, for tax purposes. This apparent circularity in the analysis—where the form of the arrangement is disregarded twice—seems unnecessary to the ultimate conclusions that the rulings reach. As a result, we question whether the conclusions that the rulings reach would really differ if the representations described above were lacking, *e.g.*, if the issuing Company and the Sponsor were affiliated.

As a result, perhaps more than usual, taxpayers who are contemplating similar products may wish to seek their own private letter rulings from the Service.

Despite the foregoing uncertainties regarding the rulings' analysis, the conclusions the rulings reach are sound. More generally, the rulings demonstrate that the Service is willing to give thoughtful consideration to the tax issues raised by new innovations in financial products, and to reach favorable conclusions that facilitate such products in appropriate cases. It is not always easy to apply tax rules that have been in place for decades to new product innovations that challenge the conventional understanding of how those rules apply. For those efforts, the Service should be commended. (See END NOTES on page 12).

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END NOTES

1 PLR 200949007 (July 30, 2009); PLR 200949036 (July 30, 2009); and PLR 201001016 (Sept. 14, 2010).

2 PLRs 200949007 and 201001016.

3 PLR 200949036.

4 Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended (the "Code").

5 Subject to certain exceptions, capital gains rates range between 0% and 15% for 2009 and 2010, whereas ordinary income tax rates range from 10 percent to 35 percent. *See* sections 1(h)(1) and 1(i). Capital gains rates are available only with respect to long-term capital gains, *i.e.,* gains from the sale or exchange of a capital asset that the taxpayer held for more than a year. *See* section 1222(11) (defining "net capital gain" for purposes of section 1(h)(1) as excluding net short-term capital gains).

6 PLRs 200949007 and 200949036 reference a maturity date, but PLR 201001016 does not.

7 PLR 200949007 states that the Certificate owner "may elect to apply the value of the Account to purchase a lifetime fixed immediate annuity contract at guaranteed purchase rates specified in the Certificate." In contrast, PLR 201001016 describes this right more generally, without any reference to guaranteed purchase rates being specified in the Certificate. It is unclear whether this was a factual difference between the rulings, or simply a matter of how the rulings were written.

8 This representation suggests that some states may not view the Certificates as annuity contracts for state law purposes. Indeed, prior to the Service issuing the three rulings, the New York State Insurance Department pronounced that a "contingent annuity contract" sharing many of the characteristics of the contracts described in the recent rulings is not permissible under New York insurance law because it constitutes a disallowed form of financial guaranty insurance. *See* OGC Op. No. 09-06-11 (June 25, 2009).

9 In simple terms, exclusion ratio treatment allows the owner to recover his or her after-tax "investment in the contract" *pro rata* over the term of the periodic payments. The rulings do not address how the investment in the contract would be determined for this purpose.

10 S. REP. NO. 97-494, at 349-50 (1982) (the "TEFRA Senate Report") (discussing the amendments made to section 72(e) by the Tax Equity and Fiscal Responsibility Act of 1982, which implemented an "income-first" ordering rule with respect to nonannuitized distributions from annuity contracts).

11 4 Am. Jur. 2d Annuities, §1.

12 For example, the rulings cite the TEFRA Senate Report for the proposition that annuity contracts involve "the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income." TEFRA Senate Report, *supra* note 10 at 349. *See also* section 72(j) (providing that if any amount is held under an agreement to pay interest, the interest payments are currently includible in gross income irrespective of any other provisions of section 72); Igleheart v. Comm'r, 174 F.2d 605, 606-07 (7th Cir. 1949) (referring to the "firmly accepted notion that an annuity has as its basic function the systematic liquidation of the principal"); Meyer v. Comm'r, 139 F.2d 256, 258-59 (6th Cir. 1943) (similar).

13 Specifically, the rulings state that the contracts and the amounts payable thereunder meet the requirements of Treas. Reg. section 1.72-1(b) and (c) (regarding the treatment of amounts received as an annuity); Treas. Reg. section 1.72-2(a)(1) (regarding the customary practice of life insurance companies); Treas. Reg. section 1.72-2(b)(3) (regarding variable annuity payments); and Treas. Reg. section 1.72-4(b)(1) (regarding the annuity starting date). We note that the reference to the variable annuity rules of Treas. Reg. section 1.72-2(b)(3) seems somewhat misplaced, as the Monthly Benefit and the Annuitized Payments would appear to be fixed in amount, rather than varying with investment performance or similar criteria.

14 Treas. Reg. section 1.72-14(a) states that an amount is considered held under an agreement to pay interest (in contrast to under an annuity contract) if the amount payable after the specified term is substantially equal to or larger than the aggregate amount of premiums.

15 While it is not clear why the lack of a cash value became an issue within the Service, possible reasons might include (1) general concern over potential collateral consequences for products that artificially depress an otherwise available cash value in order to circumvent tax rules based on that value (*see, e.g.,* 70 Fed. Reg. 48,868 (Aug. 22, 2005) (describing concern over such practices in the context of Roth individual retirement annuity conversions)), or (2) a general desire not to facilitate a perceived expansion of the types of arrangements that qualify as annuity contracts for tax purposes. These possibilities are purely the speculation of the authors, as the rulings themselves do not provide any insight on the discussions that occurred within the Service on this question.

16 PLR 200939018 (June 18, 2009). *See* also Joseph F. McKeever, III & Michelle A. Garcia, *IRS Rules Longevity Contract is Annuity under Section 72,* Vol. 6, Issue 1, *TAXING TIMES,* February 2010, at 14 (discussing PLR 200939018).

17 Appleman on Insurance § 182:05[B][7] and [8] (2d ed. 2008).

18 Section 165(c)(2).

19 Section 165(a).

20 Treas. Reg. section 1.165-1(d)(2)(i).

21 Specifically, the rulings cite to Estate of Bryan v. Comm'r, 74 T.C. 725 (1980); Forward Commc'ns Corp. v. United States, 608 F.2d 485 (1979); Johnson v. Comm'r, 66 T.C. 897 (1976), *aff'd,* 574 F.2d 189 (4th Cir. 1978); Shanahan v. Comm'r, 63 T.C. 21 (1974); Boston Elevated Rwy v. Comm'r, 16 T.C. 1084 (1951), *aff'd on another issue,* 196 F.2d 923 (1st Cir. 1952); and Dunne v. Comm'r, 29 BTA 1109 (1934), *aff'd,* 75 F.2d 255 (2d Cir. 1935).

22 *See* section 11.05 of Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 50 (stating that the Service will revoke or modify a private letter ruling retroactively if (1) there has been a misstatement or omission of controlling facts; (2) the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling was based; or (3) the transaction involves a continuing action or series of actions and the controlling facts change during the course of the transaction).

23 Absent additional legislation, capital gains treatment for QDI will not apply after 2010. *See* section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, as amended by section 102 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222.

24 Section 1(h)(11).

25 Section 246(c)(4)(C).

26 *See* Treas. Reg. section 1.246-5(b)(1) (defining "substantially similar or related property").

27 *See* section 1092(c).

28 *See* STAFF OF THE J. COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, at 282-283 (Comm. Print 1981); H.R. CONF. REP. NO. 97-176 (1981); S. REP. NO. 97-144 (1981); H.R. REP. NO. 97-201 (1981).

29 *See* section 1092(a)(3)(A)(i) (stating that unrecognized gain means, "in the case of any position held by the taxpayer as of the close of the taxable year, the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value.").

30 *See* section 6110(k)(3).

31 In particular, the rulings cite Rev. Rul. 2003-92, 2003-2 C.B. 350, and Rev. Rul. 81-225, 1981-2 C.B. 12. The following rulings also describe the investor control doctrine: Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 77-85, 1977-1 C.B. 12. *See also Christoffersen v. United States,* 749 F.2d 513 (8th Cir. 1984), *cert. denied,* 473 U.S. 905 (1985).

32 Under the investor control doctrine, the party who directs the selection, management, and disposition of the separate account assets supporting a variable contract will be considered the owner of those assets for federal income tax purposes. The relevant rulings state that this view is based on the judicial notion that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed…." *See, e.g.,* Rev. Rul. 2003-91 (quoting Corliss v. Bowers, 281 U.S. 376 (1930)). This notion, in turn, is a specific application of the long-standing judicial doctrine that the substance of an arrangement, rather than its form, controls its characterization for federal tax purposes. *See, e.g., Gregory v. Helvering,* 293 U.S. 465 (1935).

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CONFLICTING DEFINITIONS OF "SPOUSE" UNDER DOMA AND STATE LAW

By Mark E. Griffin

Under the Defense of Marriage Act of 1996 ("DOMA"), spouses are defined for purposes of federal law, including the Internal Revenue Code (the "Code"), as married individuals of the opposite sex.[1] However, an increasing number of states have extended the rights and benefits of a spouse under state law to civil union partners, domestic partners and same-sex spouses (collectively referred to herein as "Partners").[2] The interaction of these state laws with federal law can adversely affect the federal income tax treatment of nonqualified annuity contracts and qualified annuity contracts (including IRA and section 403(b) annuity contracts) with spousal provisions that are required under state law to apply to Partners.[3]

In particular, as discussed below, the application to a Partner of an annuity contract's spousal provisions that are governed by federal income tax law, such as the spousal rules under section 72(s) and section 401(a)(9), can result in the failure of the contract to satisfy these sections in form and/or operation. As a result, the contract can fail to be treated as a nonqualified or qualified annuity contract for federal tax purposes. This failure can result in severe adverse federal income tax consequences to the owner and the Partner, and can affect the issuer's withholding and reporting obligations with respect to the contract.

I. THE SPOUSAL PROVISIONS UNDER SECTION 72(s) AND SECTION 401(a)(9)

Section 72(s) sets forth certain after-death distribution requirements that a nonqualified annuity contract must satisfy in order to be treated as an annuity contract for federal income tax purposes. In particular, section 72(s)(3) provides generally that if the "holder" of a nonqualified annuity contract dies, a designated beneficiary who is the deceased holder's surviving spouse can continue the contract as his or her own annuity contract (the "spousal continuation rule"). Nonqualified annuity contracts typically contain this spousal continuation rule. Under this rule, a surviving spouse designated beneficiary is not required to take distributions that otherwise are required to be taken under section 72(s) by a nonspouse designated beneficiary. Hence, if a contract applies the spousal continuation rule to a nonspouse designated beneficiary, the contract will not require the nonspouse designated beneficiary to take distributions in accordance with section 72(s), and the contract will not be treated as an annuity contract for federal income tax purposes.

Section 401(a)(9) sets forth lifetime and after-death minimum distribution requirements that apply to qualified plans under section 401(a), qualified annuities under section 403(a), tax-sheltered annuities under section 403(b), governmental section 457(b) contracts, and IRAs. In the event that the designated beneficiary is the spouse of the employee or IRA owner (collectively, the "employee"), the following special rules apply for purposes of these requirements:

- The maximum period over which required minimum distributions may be made during the employee's lifetime is increased to the joint life expectancy of the employee and the spouse.[4]
- If the applicable distribution period over which required minimum distributions must be made after the employee's death is the designated beneficiary's life expectancy, the life expectancy can be recalculated annually if the employee's surviving spouse is the sole designated beneficiary, so that required minimum distributions can be stretched over a longer period than for a nonspouse designated beneficiary.[5]
- If the employee dies prior to the "required beginning date" by which lifetime minimum distribution must commence:
    - After-death required minimum distributions for life or life expectancy that otherwise must commence to a nonspouse designated beneficiary by the end of the calendar year following the year of the employee's death can be delayed by the surviving spouse designated beneficiary

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until the end of the calendar year following the year in which the employee would have attained age 70½;[6] and

- If the surviving spouse designated beneficiary dies before required minimum distributions commence, the after-death minimum distribution requirements are reapplied as if the surviving spouse were the employee.[7]

• In the case of an IRA, a designated beneficiary who is the deceased owner's surviving spouse may continue the IRA as his or her own, and thus delay required minimum distributions under section 401(a)(9), pursuant to a spousal continuation rule for IRAs that is similar to the spousal continuation rule for nonqualified annuity contracts.[8]

Qualified annuity contracts—including IRA and section 403(b) annuity contracts—typically include some or all of these special spousal rules under section 401(a)(9). The impact of these special rules is to delay or reduce the amount of the required minimum distributions that must be made when the employee's spouse is the designated beneficiary, as compared to the required minimum distributions that must be made to a nonspouse designated beneficiary. Hence, if these spousal rules are applied to a nonspouse designated beneficiary, the contract will not require distributions in accordance with section 401(a)(9), and thus the contract can fail to be treated as an IRA, 403(b) contract or other qualified annuity contract.

II. THE CONFLICT BETWEEN FEDERAL AND STATE LAW

As noted above, DOMA defines spouses as married individuals of the opposite sex for purposes of federal law, including the Code. Thus, for federal income tax purposes, spouses do not include: 1) civil union partners; 2) domestic partners, even if they are of the opposite sex; or 3) same-sex spouses, even though the marriage is valid under state law. As a result, in order for nonqualified and qualified annuity contracts to comply with the requirements of section 72(s) or section 401(a)(9), respectively, and enjoy the federal income tax benefits afforded to such contracts, the contract's spousal provisions that are governed by these sections must be interpreted in accordance with DOMA to apply only to married couples of the opposite sex.

However, a growing number of states extend spousal rights and benefits to Partners. This means that for contracts issued in those states, the spousal provisions in those contracts need to be applied to Partners. The problem is that if the spousal provisions are governed by federal tax law (like the spousal provisions in sections 72(s) and 401(a)(9), discussed above), applying those provisions to Partners, who are not treated as spouses under federal law, can cause the contracts to fail to constitute nonqualified annuities, IRAs, section 403(b) contracts or other qualified annuity contracts.

> ***Example.*** Assume that the "holder" of a nonqualified annuity contract dies prior to the annuity starting date, and the designated beneficiary is the holder's Partner. Under section 72(s), the entire remaining interest in the contract must be distributed: 1) within five years after the holder's death; or 2) over the Partner's life, or over a period not extending beyond the Partner's life expectancy, commencing within one year of the holder's death.[9] If the contract provides that a Partner can continue the contract under the contract's spousal continuation provision, rather than take distributions under one of these alternative distribution methods, the contract will fail to comply with the section 72(s) after-death distribution requirements. As a result, the contract will not be treated as an annuity contract for federal income tax purposes, and the tax deferral that applies to annuity contracts under the Code will be lost.

Similarly, employer and employee contributions to a "failed" qualified annuity contract will not be deductible or excludible from the employee's income under the rules that otherwise apply to qualified annuity contracts. Also, the employee might be currently taxed on the contract's earnings. It is unclear how the issuer's withholding obligations under section 3405 and the reporting obligations under section 6047 would apply with respect to a failed contract.

III. THE NEED FOR GUIDANCE

In order for employees, designated beneficiaries and insurers to understand the federal income tax treatment of their contracts, it is important that guidance be issued at the state and/or federal level that addresses this conflict between DOMA and state law. Some states (like Nevada, which extends spousal rights to domestic partners)[10] have not addressed this issue. Other states have addressed this conflict by attempting to balance the states' interests in treating Partners like spouses and the federal tax law treatment of Partners as nonspouses. Different states have taken different approaches to striking this balance.

For example, Vermont, New Jersey and New Hampshire each have laws that extend spousal rights to civil union partners, and New York law provides spousal rights to same-sex spouses in a valid out-of-state marriage. Vermont—citing consumer protection concerns over the adverse federal income tax consequences that can result from applying the spousal continuation provision of a nonqualified annuity contract to civil union partners—does not require the spousal continuation provision under a nonqualified annuity contract to be extended to civil union partners.[11] New Jersey and New Hampshire require nonqualified annuity contract forms to be amended to permit a civil union partner to continue the contract after the holder's death under the contract's spousal continuation provision, provided that the civil union partner's entire interest is distributed in accordance with the contract's after-death distribution rules under section 72(s) that apply to a nonspouse designated beneficiary.[12] New York has adopted a similar approach with respect to contracts involving same-sex spouses in a valid out-of-state marriage.[13] These different approaches are aimed generally at avoiding the conflict between state law and the application of the Code under DOMA.

The fact that different states adopt different approaches to address this conflict means that the forms and administrative procedures that annuity issuers must adopt for treating Partners will differ from state to state. Given this fact—and that not all of the affected states have addressed this conflict—it is possible that one or more states might address this conflict in a manner that jeopardizes the treatment of annuity contracts as nonqualified and qualified annuity contracts.[14] An alternative manner of resolving this conflict is for the Treasury Department or Internal Revenue Service to issue guidance clarifying the circumstances in which the requirements of sections 72(s) and 401(a)(9) will be satisfied with respect to nonqualified and qualified annuity contracts that have a designated beneficiary who is the owner's Partner and are issued in states that extend spousal rights and benefits to Partners. The attraction of this federal approach is that owners, employees, Partners and insurers could take comfort that the approach would apply in all states.

IV. CONCLUSION

As explained above, the interaction of state law with DOMA can adversely affect the federal income tax treatment of nonqualified annuity contracts and qualified annuity contracts with spousal provisions that are required under state law to apply to Partners. This interaction can result in the failure of such contracts to satisfy the applicable requirements of section 72(s) or section 401(a)(9), and thus fail to be treated as a nonqualified or qualified annuity contract for federal tax purposes. This failure can result in severe adverse federal income tax consequences to the owner and the Partner, and can affect the issuer's withholding and reporting obligations with respect to the contract. ◀

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END NOTES

1 Pub. L. No. 104-199 (1996) codified at 1 U.S.C. § 7 (1997).
2 *See, e.g., http://moritzlaw.osu.edu/library/samesexmarriagelaws.php* for a listing of states that recognize civil union partnerships, domestic partnerships and/or same-sex marriages.
3 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.
4 Treas. Reg. section 1.401(a)(9)-5, Q&A-4.
5 Treas. Reg. section 1.401(a)(9)-5, Q&A-5.
6 Section 401(a)(9)(B)(iv)(I); Treas. Reg. section 1.401(a)(9)-3, Q&A-3(b).
7 Section 401(a)(9)(B)(iv)(II); Treas. Reg. section 1.401(a)(9)-3, Q&A-5.
8 See section 408(d)(3)(C); Treas. Reg. section 1.408-8, Q&A-5.
9 Section 72(s)(1)(B) and (2).
10 S. 283, 75th Gen. Sess. (Nev. 2009).
11 Vt. Ins. Bulletin No. 128.
12 N.J. Ins. Dep't. Bulletin 07-04; N.H. Ins. Dep't Bulletin INS 08-030-AB.
13 N.Y. Ins. Dep't Supplement No. 1 to Circular Letter 27 (2008) (Dec. 9, 2009).
14 On Nov. 21, 2008, the New York State Insurance Department ("NYSID") issued Circular Letter No. 27 (2008), providing generally that annuity contracts must be amended as necessary to extend spousal rights and benefits to same-sex spouses in a valid out-of-state marriage. On Aug. 10, 2009, the NYSID released Supplement No. 1 to Circular Letter No. 27 (2008), indicating that under section 72(s), a nonspouse beneficiary can continue a nonqualified annuity contract without taking distributions, and federal income taxes will be imposed at the end of the five-year period following the contract owner's death. This Supplement also suggested that a nonspouse beneficiary can delay taking required minimum distributions under a qualified contract in the same manner that a spouse beneficiary is permitted to delay distributions under section 401(a)(9), and federal income taxes (and possibly penalties) are imposed on the nonspouse beneficiary as if required minimum distributions are actually made. Insurers raised concerns about whether the NYSID's interpretation complies with sections 72(s) and 401(a)(9). In light of these concerns, this Supplement was replaced and superseded with a new Supplement dated Dec. 9, 2009, which provides generally that a same-sex spouse beneficiary is subject to the same distribution rules under section 72(s) and section 401(a)(9) that apply to nonspouse beneficiary.

THE OPEN TRANSACTION DOCTRINE APPLIES TO THE SALE OF STOCK OF A DEMUTUALIZED LIFE INSURER IN *FISHER*, BUT SHOULD IT?

By Emanuel Burstein

In *Fisher v. United States*,[1] the Federal Circuit affirmed the decision of the Court of Federal Claims, which concluded that the "open transaction" doctrine applied to prevent the current inclusion of taxable gain resulting from the sale of stock acquired in a demutualization. The appellate court included no analysis in its *per curiam* decision, although *Fisher* involves important issues that are not fully resolved as well as tax issues that apply to millions of policyholders that have sold or will sell stock in demutualized insurance companies.

FACTS

On June 28, 1990, the Seymour P. Nagan Irrevocable Trust acquired a life insurance policy from the Sun Life Assurance Company (Sun Life), a Canadian Mutual Life Insurer. Fisher was a trustee of the Trust. For an annual premium of $19,763.76 the Trust acquired $500,000 of life insurance coverage. It also acquired certain ownership interests in Sun Life including the right to vote on certain matters, to participate in the distribution of profits and demutualization benefits, and to surplus remaining after the satisfaction of Sun Life's obligations if Sun Life became insolvent. Before the demutualization, these rights could not be sold separately from the insurance coverage and they terminated when the policy ended.

One can argue that the government's position that the sale of the Sun Financial stock was a closed transaction has considerable merit. …

Sun Life converted from a mutual to the stock form in a demutualization in 2000. The Trust received 3,892 shares of Sun Financial stock, which it subsequently sold for $31,759 on the open market. The Trust could maintain its coverage by continuing to pay annual premiums, which remained unchanged in amount from before the demutualization.

The Internal Revenue Service (IRS) issued Letter Ruling 200020048[2] and ruled, *inter alia*, that no gain was recognized by eligible policyholders when they exchanged their ownership rights for the company stock. The basis of the ownership rights carried over to the stock issued in the demutualization, which the IRS held to be zero.[3]

SALE OF A PORTION OF PROPERTY

A taxpayer generally is taxable on the amount recognized from the sale or exchange of a capital asset, such as the sale of corporate stock for cash. The amount recognized equals the excess, if any, of the amount realized over the adjusted basis of the asset sold, under sections 1001(a) and 1001(c). The amount realized equals the fair market value of the property received.

Special rules apply if the property sold is a component of a larger property. Treasury Regulation section 1.61-6 provides, in part,

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

THE OPEN TRANSACTION DOCTRINE

Instead of using a cost basis that is very speculative to compute the gain from the disposition of a portion of a larger property, the tax law treats certain dispositions as part of a transaction that remains open until the disposition of the remaining property. By integrating the transactions, any gain that would have been recognized in the initial disposition—if the open transaction doctrine had not applied—is offset by reducing the cost basis of the remaining property. This adjustment has the effect of deferring some, or all of the gain, if any, until the gain is recognized on the disposition of the second property.

In the landmark case of *Burnet v. Logan*[4] proceeds from the sale of Logan's stock included cash as well as a stream of amounts based on the total weight of ore extracted from a mine. The Supreme Court concluded that the sale of stock was not closed in 1916 when the stock was sold because the future proceeds depended on "facts and circumstances [that] were not possible to foretell with anything like fair certainty."[5] The proceeds from the stock sale were initially treated as a return of capital and taxed as recognized gain after the entire cost basis was exhausted.

The government treated the disposition of the Sun Life Financial stock in *Fisher* as a closed transaction so that the Trust recognized gain equal to cash received less the cost basis allocated to its Sun Life Financial stock. The recognized gain equaled the cash received because the cost basis, according to the government, equaled zero.

The Court of Federal Claims, however, concluded that the sale of the Sun Financial stock was an open transaction. It reasoned that the ownership rights had a value and the open transaction exception applied because one could not readily determine such value. The Trust could decrease the cost basis of the original integrated property by the amount received and recognized no gain because the cost basis exceeded the total amount received.

WAS THE SALE OF THE SUN FINANCIAL STOCK AN OPEN TRANSACTION?

One can argue that the government's position that the sale of the Sun Financial stock was a closed transaction has considerable merit, in part, because it was reasonable to treat the cost basis of the Sun Life Financial stock as zero. Treasury Regulations provide that the fair market value of property "is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value."[6] Allocating a zero cost basis to the newly issued stock does not necessarily indicate that the ownership rights lacked a value to the mutual policyholders. Rather, expert testimony indicated that the value was very small and difficult to determine and thus zero was used as a reasonable estimate.

Along the same lines, insurance company tax rules and Sun Life Financial treat the equity component of a premium paid to mutual insurers as merely incidental to the underlying insurance coverage. They, in effect, allocate the entire cost basis to the insurance coverage and nothing to the equity component. Under section 803(a)(1), a mutual life insurer includes the entire premium received in its gross income. The nonrecognition of capital contributed to a corporation in return for an equity interest in the corporation does not apply to any of the premium received.[7] Furthermore, in *Fisher,* the size of the premiums Sun Life charged for the coverage (that was integrated with the ownership rights before the demutualization) remained the same after the demutualization, when the premiums paid only for the coverage. Again, nothing was allocated to the equity component.

Treating the disposition of the stock and the subsequent termination of the insurance coverage as components of an open transaction would be flawed because the disposition of the stock and termination of insurance coverage are subject to different tax treatment. The stock disposition is taxed as the sale of a capital asset, so that any gain is taxed as capital gain. Proceeds on the disposition of a life insurance policy upon the death of the insured are completely excluded from tax under section 101 so that deferred gain would be deferred indefinitely. If a policyholder allows the coverage to lapse, the policyholder's gain, if any, would be taxed at ordinary tax rates, not as capital gain.[8]

Policyholders and insurance companies would be subject to additional recordkeeping and compliance burdens if the open transaction doctrine applied to the sale of the stock of a demutualized life insurer. They would have to know the amount of gain deferred when the stock is sold, which would adjust the policyholder's investment in the contract. Obtaining the information needed to determine the gain would be especially burdensome for insurance companies because they are not a party to the underlying stock sale and a very large number of policyholders of any given demutualized insurer would sell stock acquired in the demutualization.

AN IMPORTANT ISSUE

Fisher involves a small amount of tax liability. The tax treatment addressed in *Fisher*, however, is very significant because it involves the tax treatment of the sale of stock acquired in a demutualization. There have been numerous demutualizations, including those involving some of the giants in the insurance industry, such as Metropolitan Life and Prudential, so that millions of policyholders have sold, or will sell, stock of insurance companies acquired in demutualizations.

The Federal Circuit indicated that its decision in *Fisher* is not precedent, but a taxpayer nonetheless can rely on the decision of the Court of Federal Claims—a court of national jurisdiction—to support its view that the open transaction

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THE OPEN TRANSACTION DOCTRINE … | FROM PAGE 17

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doctrine applies to defer much, if not all, of the gain on the sale of stock acquired in a demutualization. Insurance tax practitioners stated in a summary of important policyholder tax developments in 2008[9] that numerous people who sold their stock in demutualized insurance companies have made refund requests in response to the Court of Federal Claims's decision.[10]

The IRS continues to apply the position that the basis of stock issued in a demutualization is zero. It addresses this and related tax treatment on page D-4 of its instructions for the 2009 Form 1040. In 2008, the IRS's Chief Counsel indicated in response to the Federal Claims Court's decision that "published guidance is needed very quickly."[11]

Few, if any, taxpayers will have an incentive to litigate a disagreement with the IRS on this issue because the amount of money would be relatively small. The total tax amount involved for all holders of stock acquired in a demutualization is very substantial, however.

END NOTES

1 04 CV 1726 (Fed Cir 2009) *aff'g.* 82 FedCls 780 (Fed Cls 2008).

2 Feb. 22, 2000.

3 *Id. See also* LTR 200240051 (April 16, 2002) and LTR 200011035 (Dec. 20, 1999). The basis of stock acquired in mutual holding companies also equaled zero in LTR 200111013 (Dec. 8, 2000), for example.

4 283 U.S. 404 (1931).

5 *Id.* at 413.

6 Treas. Reg. section 1.1001-1(a).

7 Section 1032(a) provides that consideration received by a corporation for its "stock" is not recognized as gain. Congress could have provided separate tax treatment for the equity component of premiums received, but did not. In fact, before it was repealed, prior-law section 809 attempted to allocate policyholder dividends distributed by mutual life insurers between equity distribution (dividend) and traditional policyholder distribution components and, in effect, prevent the deduction of the payment of the equity component of the distribution. There are times, however, when it is appropriate to bifurcate property or a transaction to reflect the underlying economics or capture the purpose of a statute. *See*, for example, E. Burstein, *Federal Income Taxation of Insurance Companies* (2nd ed.) at 179 (2007).

8 Rev. Rul 2009-13, 2009-21 I.R.B. 1029, 1030.

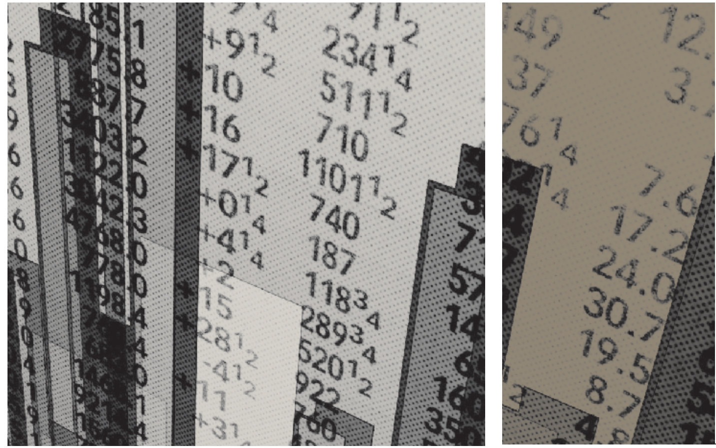
9 F. Gelfond and Y. Fujimoto, 2008 Insurance Tax Year in Review: Part II – Product Tax Matters, *Insurance Tax Review* p. 229 (Feb. 2009).

10 *Id.* at 237.

11 S. Young and C. Tandon, Korb Says IRS Considering Appeal, Guidance in Response to *Fisher, Tax Notes* p. 921 (Sept. 8, 2008).

THE LINGERING EFFECTS OF THE 2009 RMD WAIVER

By Mark E. Griffin and Joel W. Mann



Under section 401(a)(9)(H), enacted as part of "The Worker, Retiree, and Employer Recovery Act of 2008" ("WRERA"),[1] no minimum distribution is required for calendar year 2009 from individual retirement plans ("IRAs") and employer-provided qualified retirement plans that are defined contribution plans (within the meaning of section 414(i)).[2] The impact of this statutory waiver of required minimum distributions under section 401(a)(9) ("RMDs") is not limited to 2009. This discussion identifies certain situations in which the impact of the 2009 RMD waiver extends into 2010 and beyond. Issuers and providers of IRAs and employer-provided qualified retirement plans need to consider these situations and possibly modify their administrative systems and/or procedures for purposes of administering the IRAs and plans in accordance with the RMD rules.

I. BACKGROUND

Section 401(a)(9) imposes minimum lifetime and after-death distribution requirements (discussed further below) that apply to IRAs and employer-provided qualified retirement plans, *i.e.*, qualified plans under section 401(a), qualified annuities under section 403(a), tax-sheltered annuity contracts under section 403(b), and governmental section 457(b) plans. An employer-provided qualified retirement plan can be a defined contribution plan or a defined benefit plan (*i.e.*, any plan which is not a defined contribution plan).[3] A defined contribution plan is defined in section 414(i) as a plan which provides: 1) an individual account for each participant; and 2) benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and forfeitures of accounts of other participants which may be allocated to such participant's account.

Section 401(a)(9) and the regulations thereunder set forth different rules for purposes of determining the minimum distributions that are required to be made during the lifetime of the IRA owner or plan participant (collectively, the "participant") and after the participant's death. In general, if the participant is alive on his or her "required beginning date," the entire interest must be distributed, commencing no later than that date, over the participant's life (or the lives of the participant and his or her "designated beneficiary" within the meaning of section 401(a)(9)) or over a period not extending beyond the participant's life expectancy (or the life expectancy of the participant and his or her designated beneficiary). The required beginning date is April 1 following the calendar year in which: 1) the participant attains age 70½; or 2) in the case of a participant in an employer-provided qualified retirement plan who is not a 5 percent owner of the employer, the participant retires, if later.[4]

If the participant dies on or after the required beginning date, any remaining interest of the participant must be distributed at least as rapidly as under the method of distribution being used at the time of the participant's death (the "at-least-as-rapidly rule").[5] If the participant dies prior to the required beginning date, generally the participant's entire interest must be distributed: 1) by December 31 of the calendar year containing the fifth anniversary of the participant's death (the "5-year rule");[6] or 2) over either the designated beneficiary's life or a period not extending beyond his or her life expectancy, commencing no later than December 31 of the calendar year following the calendar year in which the participant dies (the "lifetime distribution rule").[7] In the case of an IRA, a surviving spouse who is the deceased IRA owner's sole designated beneficiary may elect to treat the IRA as his or her own, rather than take RMDs under these after-death distribution rules.[8]

Section 401(a)(9)(H) waives, for 2009, the minimum distribution requirement with respect to IRAs and employer-provided qualified retirement plans that are defined contribution plans. The Internal Revenue Service (IRS) published Notice 2009-9,[9] setting forth guidance to financial institutions on reporting for distributions that would be RMDs if not for the 2009 RMD waiver. These issues relating to this temporary waiver of the minimum distribution requirements were explored in an article titled "The Temporary (and Limited) Waiver of the RMD Rules for 2009" that appeared in the May 2009 issue of *Taxing Times*. Since that time, the IRS issued Notice 2009-82,[10] which provides additional guidance relating to the 2009 RMD waiver. This guidance answers a

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number of the questions regarding the waiver that remained after Notice 2009-9 was published.

For the most part, the issues relating to the 2009 RMD waiver are behind us. However, as discussed below, there are several circumstances in which the waiver will affect events in 2010 and beyond. These lingering effects of the waiver require that issuers and providers of IRAs and employer-provided retirement plans monitor these situations and possibly modify their administrative systems and/or procedures to account for these events.

II. THE POST-2009 IMPACT OF THE RMD WAIVER

Discussed below are certain situations in which the impact of the 2009 RMD waiver extends into 2010 and beyond.

A. April 1, 2010, Required Beginning Date

With respect to a living participant, a minimum distribution is first required under section 401(a)(9) for the year in which the participant attains age 70½ or, if applicable, retires.[11] However, the RMD for this first "distribution calendar year" need not be made until April 1 of the following distribution calendar year, *i.e.*, the participant's required beginning date. A separate RMD also is required for this second distribution calendar year. Hence, in the calendar year in which the required beginning date occurs, RMDs are required for two distribution calendar years—the prior calendar year in which the participant attains age 70½ or retires, as applicable, and the current calendar year.

The designated beneficiary generally must elect to take distributions under the lifetime distribution rule by the end of the calendar year following the calendar year of the participant's death.

If a participant attained age 70½ or retired, as applicable, in 2009, the required beginning date is April 1, 2010. However, no distribution is required to be made for 2009 and, thus, no RMD for 2009 is required to be made by April 1, 2010. Under the 2009 RMD waiver, the required beginning date is not delayed.[12] Hence, the participant will be viewed as having died prior to the required beginning date if he or she dies prior to April 1, 2010, and, likewise, will be viewed as dying on or after the required beginning date if he or she dies on or after April 1, 2010.[13] The RMD for 2010 must be made generally by Dec. 31, 2010.

B. The 5-Year Rule

As noted above, if the participant dies prior to the required beginning date, and the participant's entire interest is not distributed under the lifetime distribution rule, the entire interest must be distributed in accordance with the 5-year rule. Under the 2009 RMD waiver, the 5-year rule applies without regard to calendar year 2009.[14] Disregarding 2009 for purposes of applying the 5-year rule affects IRAs and employer-provided qualified retirement plans under which participants died in 2004-2008, and can directly impact RMDs for calendar years as late as 2014.

For example, if a participant died in 2004 prior to the required beginning date, under the 2009 RMD waiver, the 5-year period during which the entire interest must be distributed ends on Dec. 31, 2010 (instead of Dec. 31, 2009). Similarly, if a participant died in 2008, the 5-year period is extended by the 2009 RMD waiver from Dec. 31, 2013, to Dec. 31, 2014.[15]

C. The Lifetime Distribution Rule

Under the lifetime distribution rule, the entire remaining interest of a participant who dies prior to the required beginning date must be distributed over the designated beneficiary's life—or over a period not extending beyond the designated beneficiary's life expectancy—commencing no later than December 31 of the calendar year following the calendar year in which the participant died. The designated beneficiary generally must elect to take distributions under the lifetime distribution rule by the end of the calendar year following the calendar year of the participant's death.[16] The IRS clarified in Q&A-2 of Notice 2009-82 that in the case of a participant who died in 2008, this one-year election period is extended under the 2009 RMD waiver from year-end 2009 to year-end 2010.

The IRS provided a similar clarification with respect to direct rollovers by nonspouse designated beneficiaries from an employer-provided qualified retirement plan to an "inherited" IRA (within the meaning of section 408(d)(3)(C)). In particular, section 402(c)(11) provides generally that any portion of a distribution from an employer-provided qualified retirement plan of a deceased participant can be transferred tax free by the participant's nonspouse designated beneficiary directly to an inherited IRA that is subject to the after-death

distribution requirements under section 401(a)(9). If the plan provides that the 5-year rule is to apply where the participant dies prior to the required beginning date, the nonspouse designated beneficiary nevertheless can apply the lifetime distribution rule if the rollover is made prior to the end of the calendar year following the year of the participant's death.[17] Q&A-3 of Notice 2009-82 clarifies that if the participant died in 2008, this election period is extended under the 2009 RMD waiver from year-end 2009 to year-end 2010.

D. 2010 Rollover of 2009 RMD

An "eligible rollover distribution" (within the meaning of section 402(c)(4)) from an employer-provided qualified retirement plan generally can be rolled over tax free to an IRA or other such plan no later than the 60th day following the day of receipt.[18] Similarly, an amount distributed from an IRA to the IRA owner, or to the owner's surviving spouse, can be rolled over tax free to an IRA or employer-provided qualified retirement plan no later than the 60th day following the day of receipt of the distribution.[19] The IRS can waive the 60-day rollover deadline in certain circumstances.[20]

Under the 2009 RMD waiver, a distribution from an IRA or employer-provided qualified retirement plan that includes 2009 RMDs generally can be rolled over into the same or a different IRA or employer-provided qualified retirement plan.[21] Notice 2009-82 sets forth guidance for determining whether a distribution that includes an RMD for 2009 can be viewed as an eligible rollover distribution that is entitled to this special rollover treatment. If so, the 60-day rollover period for a 2009 RMD can extend into 2010. For example, if a participant received a distribution on Dec. 31, 2009, of an amount that, absent the 2009 RMD waiver would have been the 2009 RMD, and that qualifies for tax-free rollover treatment, the distribution can be rolled over tax free as late as March 1, 2010.

It should be noted, however, that the 2009 RMD waiver does not provide relief from the limitation in section 408(d)(3)(B) that only one distribution from an IRA can be rolled over tax free during any one-year period.[22] This one-rollover-per-year rule applies with respect to distributions during any 12-month period, and does not apply on a strictly calendar year basis. Hence, the distribution from an IRA of a 2009 RMD cannot be rolled over tax free under the 2009 RMD waiver if a distribution from the same IRA was rolled over tax free within the preceding year. Likewise, if the IRA distribution of a 2009 RMD is rolled over tax free, a distribution from the same IRA in the following one-year period may not be rolled over tax free.

E. Post-2009 Plan Amendments

Section 201(c) of WRERA provides that a plan or contract amendment relating to the 2009 RMD waiver can be delayed until the last day of the first plan year beginning in 2011 (2012 in the case of a governmental plan), provided that the plan or contract operates as if the amendment were in effect from its effective date. However, pending further guidance, IRAs do not have to be amended for section 401(a)(9)(H) in order to provide the 2009 RMD relief.[23]

III. CONCLUSION

Most of the issues relating to the 2009 RMD waiver under section 401(a)(9)(H) are behind us. However, the impact of the waiver extends beyond 2009 in a number of situations. In order to make sure that IRAs and employer-provided qualified retirement plans satisfy the section 401(a)(9) minimum distribution requirements, issuers and providers of these arrangements need to consider these situations and possibly modify their administrative systems and/or procedures to account for these situations. ◀

END NOTES

1. Pub. L. No. 110-458, 122 Stat. 5092 (2008).
2. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.
3. Section 414(i) and (j).
4. Section 401(a)(9)(C).
5. Section 401(a)(9)(B)(i).
6. Section 401(a)(9)(B)(ii); Treas. Reg. section 1.401(a)(9)-3, Q&A-2.
7. In the case of a designated beneficiary under en employer-provided qualified retirement plan, distribution under the lifetime distribution rule can be delayed under section 401(a)(9)(B)(iv) until December 31 of the year following the calendar year in which the participant would have attained age 70½.
8. Treas. Reg. section 1.408-8, Q&A-5.
9. 2009-5 I.R.B. 419.
10. 2009-41 I.R.B. 491.
11. Treas. Reg. section 1.401(a)(9)-5, Q&A-1(b).
12. Section 401(a)(9)(H)(ii)(I).
13. Staff of J. Comm. on Tax'n, 110th Cong., Technical Explanation of H.R. 7327, the "Worker, Retiree, and Employer Recovery Act of 2008," as passed by the House on December 10, 2008, at 26-27 (J. Comm. Print 2008) ("WRERA Bluebook").
14. Section 401(a)(9)(H)(ii)(II).
15. WRERA Bluebook at 27.
16. Treas. Reg. section 1.401(a)(9)-3, Q&A-4(c).
17. *See* Q&A-17(c)(2) of Notice 2007-7, 2007-1 C.B. 395.
18. Section 402(c); section 403(a)(4)(B); section 403(b)(8)(B); section 457(e)(16)(B).
19. Section 408(d)(3).
20. Section 402(c)(3)(B); section 408(d)(3)(I).
21. *See* section IV and Q&A-6 of Notice 2009-82.
22. *See* Q&A-4 of Notice 2009-82.
23. *See* Q&A-1 of Notice 2009-82.

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ACLI UPDATE

ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS AFFECTING LIFE INSURANCE COMPANIES AND PRODUCTS

By Walter Welsh and Mandana Parsazad

On Feb. 1, 2010, the Obama Administration released its Fiscal Year 2011 Revenue Proposals; among these are five proposals that directly affect the taxation of life insurance companies and products. Four of this year's proposals appeared in the Administration's Revenue Proposals last year and did not move forward. These 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;
3. Modify rules that apply to sales of life insurance contracts; and
4. Require information reporting for private separate accounts of life insurance companies.

The first three of these proposals appeared in a section entitled, "Other Revenue Changes and Loophole Closers," under the subheading "Reform Treatment of Insurance Companies and Products." The fourth proposal was included in a section entitled, "Reduce the Tax Gap and Make Reforms." The fifth revenue proposal, which is new this year and also included in the section entitled, "Other Revenue Changes and Loophole Closers," would permit partial annuitization of a nonqualified annuity contract. The Fiscal Year 2011 Budget revenue estimates for these five proposals totals $14.5 billion over 10 years. Following is a more detailed description of each proposal.

1) PROPOSAL TO EXPAND THE PRO RATA INTEREST DISALLOWANCE FOR COLI, EFFECTIVE FOR CONTRACTS ENTERED INTO AFTER DEC. 31, 2010.[1]

This proposal, essentially unchanged from last year's version, would disallow an interest deduction to a company to the extent of the unborrowed cash value of its COLI policies on the lives of all except for 20-percent owners of the company or business. Such a disallowance would repeal the current exception to the interest disallowance rule for COLI policies on the lives of individuals who are officers, directors or employees, and would effectively eliminate the benefits of inside build-up on policies on the lives of those individuals. 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.

2) PROPOSAL TO MODIFY THE DRD FOR LIFE INSURANCE COMPANY SEPARATE ACCOUNTS, EFFECTIVE FOR TAXABLE YEARS BEGINNING AFTER DEC. 31, 2010.

This proposal also remained essentially unchanged from last year's version. All corporate taxpayers are allowed the DRD, which permits them to exclude from taxable income a portion (at least 70 percent) of dividends that they receive. For many years, life insurance companies and their separate accounts have been subject to rules that limit the deduction of their DRD to their "company share" of the DRD. This proposal would change the formula for measuring required interest, which is used to determine a life insurance company's share of the DRD. The result of the proposal would be a separate account DRD that is largely unrelated to the separate account's economic interest in its dividend-yielding investments. 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 mechanism based on tax policies that has worked well for many years. A change that singles out one particular segment of that mechanism for revision is inappropriate.

3) PROPOSAL TO MODIFY RULES THAT APPLY TO SALES OF LIFE INSURANCE CONTRACTS, EFFECTIVE AFTER DEC. 31, 2010.

This proposal also remained essentially unchanged; it would require anyone who purchases from a third party an interest in an existing life insurance contract with a death benefit equal to or greater than $500,000 to report to the Internal Revenue Service (IRS), to the issuing company and to the seller infor-

mation about the purchase. The proposal would also require that upon payment of any death benefit under the affected policy, the insurer must issue an IRS Form 1099 to the payee. The Fiscal Year 2011 version of this proposal lowers the application of the reporting requirement to interests in contracts with death benefits equal to or greater than $500,000; last year's revenue proposal applied to purchases of interests in life insurance policies of $1 million or greater.

The Administration's description states that information reporting would bolster the transfer for value rules in section 101(a)(2) and suggests that it may prevent the inappropriate use of exceptions to the transfer for value rules by taxpayers that purchase life insurance policies.

4) PROPOSAL TO REQUIRE INFORMATION REPORTING FOR PRIVATE SEPARATE ACCOUNTS OF LIFE INSURANCE COMPANIES, EFFECTIVE FOR TAXABLE YEARS BEGINNING AFTER DEC. 31, 2010.

This proposal also remained unchanged; it would require life insurance companies to report to the 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 defines 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. This year's proposal clarifies that the timing for measuring the cash values in the accounts would be determined on a quarterly basis, and states that reporting would be required for persons who own at least 10 percent of the value of the account.

ACLI will continue to actively oppose the proposals on COLI and DRD. 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.

5) PROPOSAL TO PERMIT PARTIAL ANNUITIZATION OF A NONQUALIFIED ANNUITY CONTRACT, EFFECTIVE AFTER DEC. 31, 2010.

This proposal would apply the exclusion ratio to amounts received as an annuity when a taxpayer elects to annuitize a portion of an existing nonqualified deferred annuity contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis. Specifically, the proposal would permit the application of the exclusion ratio to the portion of the contract selected for annuitization if the taxpayer irrevocably elects to annuitize that portion of the annuity contract for life or a period of at least 10 years. The proposal describes the current partial exchange rules as permitting the exchange of a portion of an annuity contract for a second contract and, under certain circumstances, annuitizing one of the contracts, and concludes that it is appropriate for a partial annuitization of an annuity contract to be treated consistent with partial exchange transactions.

For a number of years ACLI has sought administrative guidance from the Treasury Department and the IRS that would permit partial annuitization through exchanges of annuity contracts and direct partial annuitization of an annuity contract. We expect to continue to work with the Administration on guidance and support this proposal.

FINANCIAL CRISIS RESPONSIBILITY FEE

The Administration's Fiscal Year 2011 Budget also included a revenue proposal previously unveiled on Jan. 14 of this year as the "Financial Crisis Responsibility Fee." This revenue proposal would impose a fee of 15 basis points on the consolidated liabilities of financial firms with consolidated assets of $50 billion or more that owned or controlled banks, thrifts, bank or thrift holding companies, brokers and securities dealers as of Jan. 14, 2010. While as described, the proposal seems to be aimed at banks and broker-dealers, the description that includes "U.S. companies owning or controlling these types of entities" causes concern for insurance companies. The fee is described as providing a deterrent against excessive leverage. Insurers are subject to state insurance regulation which contains a number of mechanisms for considering insurance company leverage. Given this system of regulation, any such fee should have limited application to insurers. Assessments on financial firms are also under consideration in the development of Federal financial services reform legislative proposals. The ACLI has been significantly engaged in this legislative effort on financial services reform.

END NOTES

[1] The proposal would also apply to previously issued contracts if the death benefit is materially increased, or other material changes are made that cause the contracts to be treated as having been issued after the effective date of the provision.

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IRS TO REQUIRE DISCLOSURES OF UNCERTAIN TAX POSITIONS

By Samuel A. Mitchell and Peter H. Winslow

For the last three years since the FIN 48 accounting interpretation became effective,[1] corporate tax departments and professionals have been concerned that the increased financial accounting disclosures would lead to more Internal Revenue Service (IRS) scrutiny of the uncertain tax positions and attempts by the IRS to gain access to tax accrual workpapers that contain confidential descriptions and analysis of the positions. The IRS takes the position that it has the right to compel disclosure of confidential tax accrual workpapers under the leading Supreme Court case,[2] but it has chosen as a matter of administrative practice to request the workpapers only in certain limited circumstances in which taxpayers invest in abusive tax shelter transactions. The policy of restraint is described in Announcement 2002-63,[3] and the Internal Revenue Manual,[4] and is based on competing objectives: that routine disclosure of accrual workpapers would provide a disincentive for accurate and candid financial reporting analysis, but limited disclosure for tax shelters would provide an incentive not to enter into abusive transactions.

Since the adoption of FIN 48, various IRS officials have publicly stated that the IRS is reconsidering its policy of restraint under Announcement 2002-63 in light of FIN 48, suggesting that transparency should be the principal objective in a voluntary compliance tax system. In the meantime, the IRS has engaged in significant litigation in which taxpayers asserted the work product doctrine and other grounds in an attempt to protect workpapers the IRS sought in tax shelter cases. The concerns about the IRS's intentions came to a head recently when the First Circuit Court of Appeals ruled in favor of the IRS and against the taxpayer in *United States v. Textron*,[5] ruling that the IRS should have access to the company's tax accrual workpapers.[6]

It turns out that concerns about the IRS's intentions have been well-founded. The IRS announced in January that taxpayers with assets in excess of $10 million will be required to disclose their uncertain tax positions on a schedule attached to their tax returns. Taxpayers will be required to disclose details of each position (*e.g.,* tax years affected), the rationale for the position, the reason the position is uncertain, and the amount of federal income tax that would be due if the position were disallowed by the IRS on examination. Moreover, taxpayers will be required to disclose certain positions regardless of whether they have established reserves for the positions under FIN 48. This means that taxpayers will have to disclose the positions for which they did not establish a reserve because they intend to litigate the matter or because they believe that the IRS as a matter of administrative practice will not raise the issue.[8] Commissioner of Internal Revenue Douglas Shulman has said that the IRS's goal in requiring the schedule is to reduce the time spent selecting taxpayers and issues for audit.

Under the new disclosure regime, the IRS should have a roadmap to uncertain tax positions identified by the taxpayer and a gauge to evaluate the materiality of each position. The gauge will be crude, and frequently unreliable, because the required disclosure will be the maximum tax assessment possible without any consideration of the merits of the issue. Commissioner Shulman has said that the IRS only expects to require concise information and no information concerning the strengths or weaknesses of the uncertain positions, although the announcement seems to suggest that the IRS may want more detail notwithstanding the Commissioner's comments. The IRS states that it is still abiding by its policy of restraint in Announcement 2002-63, and therefore is not asking for the taxpayer's evaluation of the merits of each issue or the actual amount the taxpayer has reserved for financial accounting purposes for each issue. Nevertheless, the disclosure will require descriptions of matters that are highly confidential, including reasons why each issue is uncertain, the Internal Revenue Code sections that potentially apply, and other detailed information. Attorney-client privilege and work product issues inevitably will arise if the IRS disclosure requests are too broad.

Under the current law, taxpayers generally are not required to report detailed descriptions of particular items on their tax returns unless they have determined that they have less than substantial authority for the position, the item has been

designated as an abusive tax avoidance transaction, or the item falls within some other specific disclosure requirement, such as the requirement to describe differences between book and tax treatment. Unlike these existing disclosure requirements, which are backed by penalties for failure to disclose, there is no specific penalty for a taxpayer's failure to disclose uncertain tax positions on a tax return. As a result, the IRS is considering whether it can extend any existing penalties to this situation and whether to seek new legislation imposing penalties for failure to make the disclosures. An IRS official also has stated that a penalty for filing an incomplete schedule might apply, but it is unclear what this penalty may be.[9] If the IRS determines that an imposition of a specific monetary penalty is problematic, it is likely to resort to a procedural "penalty" for failure to provide the schedule, such as more vigorous audits of non-compliant taxpayers.

In a follow-up announcement, the IRS has stated that the schedule will apply to calendar-year 2010 returns and fiscal year returns that begin in 2010.[10] The follow-up announcement clarifies that the schedule will not be required for 2009 returns and requests comments on its implementation. The comments are due to be submitted by June 1, 2010.[11]

It is difficult to overstate the significance of the new disclosure requirements. The disclosures could change the way taxpayers think about adopting uncertain tax positions (particularly those that do not satisfy the more-likely-than-not FIN 48 threshold). On the other hand, the IRS's behavior on audit possibly could change, with agents more reluctant to waste their effort examining issues that the taxpayer and outside auditors already have determined are not uncertain.

END NOTES

1. FIN 48 (FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109) became effective for most publicly traded taxpayers for fiscal years beginning after December 15, 2006. The interpretation is now codified at FASB Accounting Standards Codification subtopic 740-10, *Income Taxes.* FASB ASC 740-10.
2. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).
3. 2002-2 C.B. 72.
4. IRM 4.10.20.3.1.
5. *United States v. Textron,* Inc., 577 F.3d 21 (1st Cir. 2009). Petition for certiorari filed with the Supreme Court on Dec. 24, 2009, No. 09A361.
6. For a discussion of the Textron case before the appeal, *see What Does Textron Mean for Preserving the Confidentiality of Tax Accrual Workpapers?*, 4 *TAXING TIMES* 20 (May 2008).
7. Announcement 2010-9, 2010-7 I.R.B. 408.
8. Under FIN 48, taxpayers must hold a 100 percent tax reserve for positions which do not satisfy the more-likely-than-not-to-prevail (MLTN) standard. For uncertain positions on which taxpayers have determined that they are more likely than not to prevail in court, a tax benefit is recognized for the largest amount that is greater than 50 percent likely to be realized on ultimate settlement. Many taxpayers do not hold any reserve under the FIN 48 interpretation for MLTN positions which they intend to litigate if challenged and do not intend to entertain a settlement. Additionally, the interpretation does not require a reserve for issues that the IRS has determined as a matter of administrative practice that it will not examine.
9. J. Coder, "LMSB Commissioner Fields Questions on Reporting Uncertain Tax Positions," *Highlights & Documents* 941, 942 (Tax Analysts Feb. 23, 2010).
10. Announcement 2010-17, 2010-13 I.R.B. 515. The Announcement states that the schedule will be released in draft form in April, 2010. Note that the draft schedule had not been released as of the final deadline for submitting this article.
11. This is a 60-day extension of the comment period announced in Announcement 2010-9, *supra*.

DISALLOWED INTEREST REDUCES EARNINGS AND PROFITS IN THE CURRENT YEAR

By Stephen Baker

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A corporation determines if a distribution is a dividend to its shareholders by reference to Earnings and Profits ("E&P"). There is little legislative or administrative guidance relative to the computation of E&P, yet corporations face E&P calculation questions frequently in the ordinary course of business. Each item of revenue or expense may impact E&P. One such item that impacts E&P is interest on indebtedness. What happens when that interest is not deductible? Revenue Ruling 2009-25 addresses that question.[1]

Section 163[2] generally allows a deduction for interest paid or accrued on indebtedness within the taxable year.[3] However, section 264(a)(4) generally disallows a deduction for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies or any endowment or annuity contracts owned by the taxpayer covering any individual.[4] Even though disallowed as a deduction, the interest has still been paid or accrued on a policy, endowment or annuity, and, consequently, there will be a reduction to E&P for the interest. On Sept. 8, 2009, the Internal Revenue Service ("Service") released Rev. Rul. 2009-25,[5] addressing the proper timing

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of the reduction in E&P for the interest paid or accrued. The Service ruled that:

> Disallowed Interest under § 264(a)(4) reduces earnings and profits for the taxable year in which the interest would have been allowable as a deduction but for its disallowance under § 264(a)(4). It does not further reduce earnings and profits when the death benefit is received under a life insurance contract. [6]

In the ruling, the Service used a fairly straightforward fact pattern.

> A, an individual, holds a paid-up life insurance contract on his own life. Upon the death of A, the $500 death benefit under the contract is payable to the beneficiary named in the contract. X is a calendar year subchapter C corporation unrelated to A.
>
> On the first day of Year 1, X purchases A's life insurance contract for $100 and names itself the beneficiary under the contract. The purchase transaction is one whereby the underlying contract does not have a basis for determining gain or loss in the hands of the transferee that is determined in whole or in part by reference to such basis in the hands of the transferor. Thus the purchase is not a transaction that is described in § 101(a)(2)(A) or (B).[7]
>
> On the first day of Year 1, X borrows $100 at 7 percent simple interest per annum to purchase the life insurance contract. The interest on the loan is unconditionally payable at the end of Year 1 and Year 2 and the interest was in fact paid at the end of Year 1 and Year 2. But for its disallowance under § 264(a)(4), X could deduct seven dollars of interest on the loan in both Year 1 and Year 2 under § 163. Other than the initial purchase price, the interest on the loan is the only amount X incurs in connection with the contract.
>
> A dies on the first day of Year 3, and X receives the $500 death benefit under the life insurance contract. Pursuant to § 101(a)(2), X includes $386 in gross income ($500 (death benefit) - ($100 (amount paid for the contract) + $14 (Disallowed Interest deductions in Year 1 and Year 2))).

Leading up to its analysis of E&P, the Service discusses the general rule of excluding from gross income amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.[8] The analysis also includes a brief mention of the exceptions to this general rule:

- A life insurance contract that is transferred for value,[9]
- Payment on a life insurance contract at a date later than death,[10]
- Certain contracts issued before Jan. 1, 1985;[11] and
- Certain employer owned life insurance contracts.[12]

The analysis then continues with a short mention of the general deduction allowed for interest paid or accrued within the taxable year on indebtedness, section 163(a), and the disallowance of that deduction, section 264(a)(4). The discussion on E&P is just over one half-page, and while not voluminous, develops the appropriate ruling. The analysis begins with a Senate Report definition of E&P "… a measure of economic income, or a corporation's capacity to pay dividends."[13]

The discussion then cites Rev. Rul. 75-515[14] which, although made obsolete by Rev. Rul. 2003-99,[15] still provides valuable discussion of the computation of E&P. Rev. Rul. 75-515 provides that:

> In general, the computation of earnings and profits of a corporation … is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitation provided therefore [sic], and other items that have actually depleted the assets of the corporation, even though not reflected in the income computations, are allowed as deductions in computing earnings and profits.[16]

It is also interesting to note that Treasury Regulations discuss the need that due consideration be given to the facts. While mere bookkeeping entries increasing or decreasing surplus will be considered, generally they will not be conclusive; the amount of E&P in any case will depend upon the method of accounting properly employed.[17] There is, as one would hope, a general consistency between the Revenue Rulings to date and the Treasury Regulations, requiring reasonable and proper accounting treatment.

After discussing the computation of E&P, the ruling goes on to cite two pertinent revenue rulings; Rev. Rul. 71-165[18] and Rev. Rul. 77-442.[19] Rev. Rul. 71-165 holds that a nondeductible expense of an accrual basis corporation reduces E&P in the year in which the expense is realized and recognized, unless the Code specifically provides otherwise. Rev. Rul. 77-442 holds that because disallowed interest depletes the assets of a corporation at the time the interest would be allowed as a deduction but for its disallowance under section 264(a)(4), E&P are also reduced in that year. Thus, following the logic of the above two revenue rulings, the Service holds in Rev. Rul. 2009-25 that "X in both Year 1 and Year 2 reduces its earnings and profits by the seven dollars of Disallowed Interest."

The next section of the discussion focuses on the impact of the year three events, *i.e.,* X receives the $500 death benefit under the life insurance contract purchased from A. The ruling holds to the guidance provided under Treasury Regulation section 1.312-6(d) which states that a loss sustained for a year before the taxable year does not affect the E&P of the taxable year. The service then goes on to cite Rev. Rul. 76-299[20] for the proposition that "A capital loss carryover does not affect the E&P of the taxable year in which it is used because the loss giving rise to the carryover is reflected in the accumulated earnings and profits at the beginning of the taxable year of the carryover." Based upon this logic, there is no further reduction of E&P in Year 3 for the previously Disallowed Interest.[21]

By year 3, X has already reduced its E&P for the Disallowed Interest. Therefore, X includes $400 ($500 (the death benefit) less $100 (the amount X pays for the contract)) in its E&P in Year 3. However, for income tax purposes, in Year 3, X includes in its gross income only $386 of the $500 death benefit because of the applicable offsets under section 101(a)(2) for the $100 paid for the policy and the $14 of Disallowed Interest. The ruling does not address the timing of the impact of the death benefit on E&P. Aside from pronouncements in the excess profits tax area, the Service has issued only one pronouncement addressing this directly. Rev. Rul. 54-230[22] states that "the excess of the insurance proceeds received by the corporation over the aggregate sum of the premiums paid will constitute earnings and profits available for distribution."

It is interesting to note that there was no administrative or judicial guidance directly on point prior to the issuance of this ruling. Based upon the logic and definitions above, the ruling reaches the proper result.

END NOTES

1. Revenue Ruling 2009-25, I.R.B 2009-38, Sept. 4, 2009.
2. Except as otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
3. I.R.C. §163(a).
4. I.R.C. §264(a)(4).
5. Revenue Ruling 2009-25, I.R.B 2009-38, Sept.4, 2009.
6. Rev. Rul. 2009-25, Holding.
7. This section defines a "Transfer for Value" transaction. A policy that is transferred for a valuable consideration loses most of the income tax-free character of its death proceeds. If a transfer for value occurs, the death proceeds are excludable from the recipient's income only to the extent of the value of the consideration paid plus the amount of any subsequent premiums and other amounts paid by the transferee.
8. I.R.C. §101(a)(1).
9. I.R.C. §101(a)(2).
10. I.R.C. §101(d).
11. I.R.C. §101(f).
12. I.R.C. §101(j).
13. S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., 198 (1984).
14. Rev. Rul. 75-515 , 1975-2 C.B. 117, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388 (holding codified in § 312(l)).
15. Rev. Rul. 2003-99, 2003-2 C.B. 388 (holding codified in § 312(l)).
16. Rev. Rul. 75-515.
17. Treas. Reg. §1.312-6(a).
18. Rev. Rul. 71-165, 1971-1 C.B. 111.
19. Rev. Rul. 77-442 ,1977-2 C.B. 264 (quoting Rev. Rul. 71-165 and Rev. Rul. 75-515).
20. Rev. Rul. 76-299 , 1976-2 C.B. 211.
21. For additional support on this point see for example *Bangor & Aroostook Railroad Co. v. Commissioner*, 16 T.C. 578, 586 (1951), *aff'd* 193 F.2d 827 (1st Cir. 1951).
22. Rev. Rul. 54-230, 1954-1 C.B. 114.

SSAP 43R AND TAX STANDARDS FOR PARTIAL WORTHLESSNESS DEDUCTIONS

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In September 2009, the NAIC adopted Statement of Statutory Accounting Principles 43R (SSAP 43R), providing guidance effective as of Sept. 30, 2009, for the impairment of loan-backed and structured securities. SSAP 43R replaced SSAP 98, which was an amendment to SSAP 43 and SSAP 99 paragraph 13. The adoption of SSAP 43R, and the movement away from the fair value approach of SSAP 98, may facilitate claims of partial bad debts under Internal Revenue Code section 166 for debts that do not qualify as securities for tax purposes. This is because the new SSAP isolates credit-related impairments (potentially available for bad debt treatment) from interest-related impairments (that the Internal Revenue Service (IRS) is likely to challenge if claimed as a tax deduction). [1]

SSAP 43R requires a charge against current statutory earnings for Other-Than-Temporary impairments that are

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credit-related to the extent the discounted expected cash flows are less than book value. It requires a further impairment to fair value and a charge against current earnings only if the company has the intent to sell the instrument or does not have the ability to hold it until recovery. In the latter situation, the standard requires the company to disclose the amount of the impairment to fair value that is interest-related.

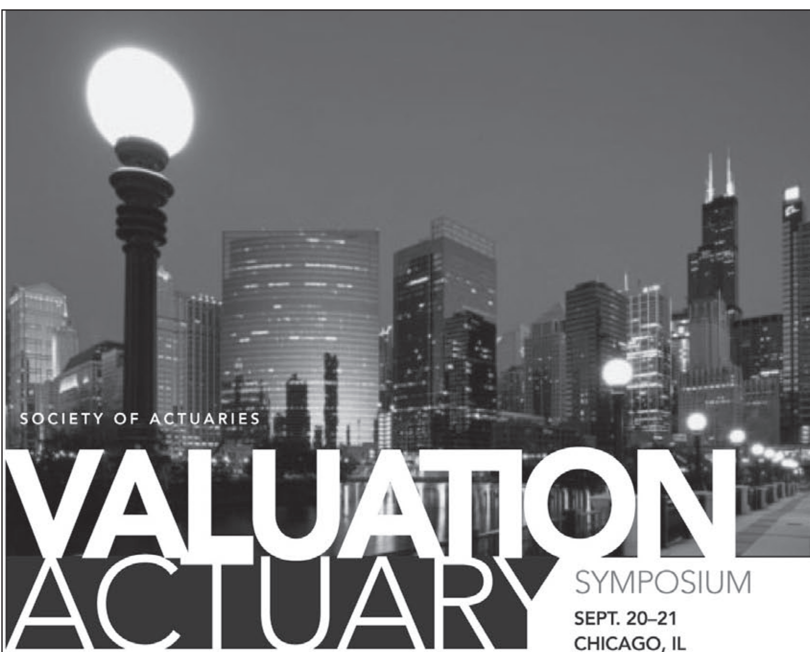
The Other-Than-Temporary impairments insurance companies have recorded for instruments such as REMIC regular interests under SSAP 43R and earlier standards may be eligible for partial worthlessness deductions of debts held by insurance companies.[2] Under the tax standards, a taxpayer that holds a business debt that is not considered a security under section 165(g) has the discretion to take a tax deduction for partial worthlessness rather than wait until disposition or total worthlessness to realize the tax loss. Partial worthlessness deductions are advantageous for both timing and character. The timing benefit arises because the alternative, which applies to securities under section 165(g), is to wait either until the taxpayer sells the instrument or until the instrument becomes wholly worthless. The character benefit arises because partial worthlessness deductions are charged against ordinary income, whereas losses on disposition, and in some cases losses on total worthlessness, are capital losses. Capital losses can be used only to offset capital gains and are subject to expiration after five tax years if not used.[3]

Thus, taxpayers have a strong incentive to claim partial worthlessness deductions for impairments they have charged off their books. In order to qualify for a partial worthlessness deduction, the taxpayer must prove that the instrument is partially worthless and the deduction is limited to the amount the taxpayer has charged off as worthless on its books.[4] The tax standard for proving partial worthlessness is relatively stringent, but insurance companies may have fewer proof problems than other taxpayers because they may be able to take advantage of a conclusive presumption in the Treasury Regulations that applies to banks and other similarly regulated industries. Under the conclusive presumption, at Treasury Regulation section 1.166-2(d), a regulated company's book charge-off is presumed correct if it is made under established policies and procedures of the regulator and if the regulator confirms this fact in writing upon its first examination of the company's books for the year of the charge-off. Recently, many insurance companies have requested their state insurance departments to send them charge-off letters to comply with the Treasury Regulations, and several state regulators have sent the requested letters.

There may be a problem with at least a portion of a partial worthlessness deduction, even under the conclusive presumption, if the amount charged off under the standard for measuring an Other-Than-Temporary impairment for statutory accounting exceeds the amount that is associated with a credit-related impairment.[5] For banks, the IRS has held that the conclusive presumption does not apply to a write-down to fair value, even if the bank's regulator has ordered the charge-off.[6] This presumably is because the interest-related portion of a write-down to fair value may be recovered if the instrument is held long enough, and the tax standard allows only for permanent impairments that reflect a loss of basis that the taxpayer cannot recover. SSAP 43R's focus on credit-related events should be of benefit to insurance company taxpayers who seek to take advantage of the conclusive presumption. Even in cases in which the impairment is to fair value, the conclusive presumption nevertheless may apply because the standard requires identification of the portion that is interest-related.

END NOTES

1 *Tax Aspects of Nonperforming Assets*, 4 TAXING TIMES 28 (Sept. 2008); *REMIC Impairments May Qualify as Worthless Bad Debts*, 5 TAXING TIMES 50 (May 2009).
2 *Id.*
3 The losses are first carried back to the previous three tax years, and unused amounts are carried forward. The amounts carried forward expire if unused in the succeeding five tax years. *See generally* I.R.C. § 1212(a).
4 *See generally* I.R.C. section 166.
5 *Id.*
6 *See* Revenue Ruling 84-95, 1984-2 C.B. 53.



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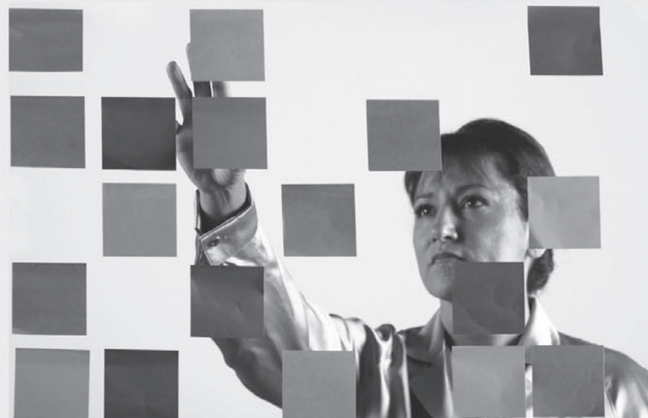

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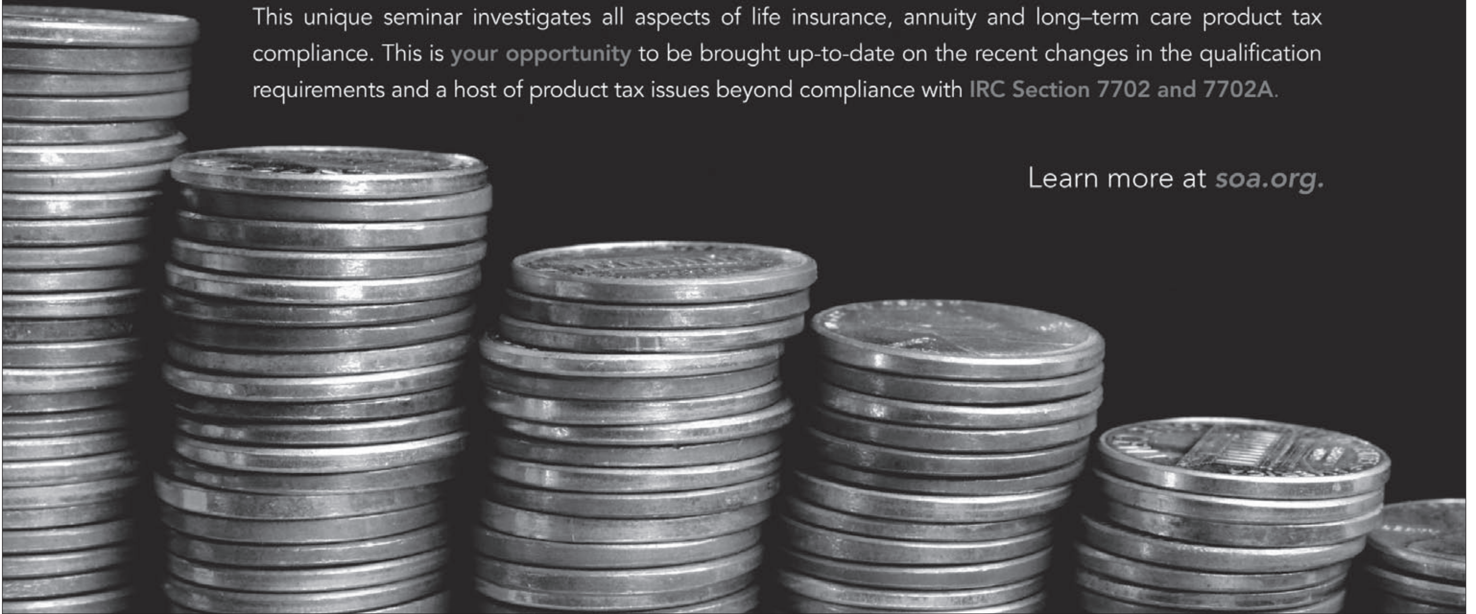

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