Taxing Times

May 2010 – Volume 6 Issue 2

ACLI UPDATE

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

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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 information 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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