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# TAPPING A NEW REVENUE SOURCE—CONGRESS EXPANDS THE MEDICARE TAX BASE TO INCLUDE INCOME FROM "ANNUITIES"

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Last March, Congress passed and the President signed the Patient Protection and Affordable Care Act[1] followed by the Health Care and Education Reconciliation Act,[2] which amended the former (collectively, the "Act"). While the overall impact of the massive health care reform legislation remains to be seen, one change is noteworthy for life insurance companies and their policyholders. Specifically, the Act altered the Medicare Hospital Insurance ("HI") tax by increasing the tax on the earned income amounts of high income taxpayers and by adding a new 3.8 percent tax on certain types of "net investment income" of those taxpayers (referred to herein as the "Investment Income Tax"[3]). As detailed below, of key importance to life insurers is that the definition of net investment income includes gross income from nonqualified "annuities" as well as from certain dispositions of property, which could implicate transactions involving life insurance contracts.

The first part of this article provides a brief background on the passage of the Act generally and the creation of the new Investment Income Tax in particular. The article next compares the existing provisions of the HI tax with the newly enacted provisions, and it then analyzes the import of the Investment Income Tax for annuities and, possibly, life insurance contracts. The article concludes with thoughts on the potential effect of the new tax on the annuity marketplace.

## BACKGROUND

By late in 2009, health care reform proposals had gained considerable momentum due to a Democratic majority in both chambers of Congress, including a so-called supermajority of 60 votes in the Senate. Last January, however, this momentum slowed when Massachusetts elected a Republican senator, Scott Brown, bringing an end to that supermajority. By that point, two very different bills had passed the House and the Senate. For health care legislation to be enacted over Republican objections, the Obama Administration suggested using the "reconciliation" process, which only requires a simple majority vote for legislation to pass the Senate. On Feb. 22, 2010, the Obama Administration released a number of proposals designed to bridge the gap between the House and Senate bills. The congressional leadership agreed to follow this approach, ultimately resulting in passage of the legislation the following month.

In order to fund its proposals for concluding the health care enactment, the Obama Administration included several "policies to contain costs and ensure fiscal sustainability" (*i.e.*, revenue raisers), one of which was to "broaden the Medicare Hospital Insurance (HI) tax base for high-income taxpayers." The measures included an increase in the HI tax rate on the earned income of high income taxpayers and the addition of a new tax on high income taxpayers' "unearned" investment income (*i.e.*, the "Investment Income Tax"). The Act generally adopted the proposals to increase and expand the Medicare HI tax, estimated to raise over $210 billion in federal tax revenue over the ensuing 10 fiscal years.

## DESCRIPTION OF NEW PROVISIONS

### HI Tax on Earned Income

Currently, the HI tax is imposed on individuals as a percentage of their wages or self-employment income, *i.e.*, the tax generally applies only to income earned as compensation for personal services. The current tax rate is 2.9 percent, with employees paying half and their employers paying the other half (and with a self-employed individual paying tax at the full 2.9 percent rate subject to the deduction allowed on the individual's income tax return for a portion of this amount).

The Act increases by 0.9 percent the existing HI tax imposed on certain wage and self-employment income of high income taxpayers, effective for taxable years beginning after Dec. 31, 2012. This tax is added to the current employee share of the HI portion of payroll taxes on wages (FICA) and to the corresponding self-employment (SECA) tax. The 0.9 percent tax will apply to the extent that combined wage and self-employment income exceeds $200,000 for individuals or

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$250,000 for married taxpayers (filing joint returns). Unlike the thresholds for the 3.8 percent Investment Income Tax described more fully below, only wages and self-employment income are taken into account in determining whether a taxpayer has income in excess of the thresholds, *i.e.,* investment income is disregarded. The additional revenues from the 0.9 percent tax increase will be credited to the HI Trust Fund (as are current Medicare tax revenues), which generally funds Medicare benefits.

**Investment Income Tax**

As already noted, the Act includes a provision that expands the HI tax base for high income taxpayers to cover certain specified forms of investment income. Effective (like the tax rate increase just described) for taxable years beginning after Dec. 31, 2012, new section 1411[4] expands the base by applying the HI tax to investment income at the 3.8 percent rate. In the case of an individual,[5] the 3.8 percent rate applies to the lesser of a) "net investment income" or b) the excess of the taxpayer's modified adjusted gross income ("MAGI") over a specified income threshold.[6] The income thresholds are $250,000 for married couples filing jointly,[7] $125,000 for married couples filing separately,[8] and $200,000 for everyone else,[9] with none of these amounts being indexed for inflation in future years. MAGI is adjusted gross income, as that term is generally defined,[10] increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions allowed with respect to the foreign earned income).[11] Taxpayers with MAGI at or below the applicable income threshold are not subject to the tax, irrespective of their net investment income.

> *Example*: Assume that taxpayers filing a joint return have MAGI of $300,000, which exceeds the applicable income threshold by $50,000. The $50,000 excess amount effectively acts as a cap on their Investment Income Tax. If their net investment income exceeds $50,000, they will still pay the Investment Income Tax only on $50,000, and if their net investment income is less than $50,000, they will pay the Investment Income Tax only on that lesser amount. If they have no net investment income, or if their MAGI were less than $250,000, they would not owe the Investment Income Tax.

New section 1411(c) defines net investment income as 1) "gross income from interest, dividends, annuities, royalties, and rents," plus 2) any other gross income derived from a trade or business in which the taxpayer participates only passively or that is a business of trading in financial instruments or commodities, plus 3) net gain from dispositions of property to the extent taken into account in computing taxable income (subject to a special rule for property held in a noninvestment business), minus 4) otherwise allowable deductions properly allocable to the foregoing.

The additional revenues from the Investment Income Tax will not be set aside for the HI Trust Fund to fund Medicare benefits; instead the revenue raised by this tax will increase general federal revenues. Thus, while the new Investment Income Tax is labeled the "Unearned Income Medicare Contribution," it technically has nothing to do with Medicare funding and amounts to a new, general tax on the investment income of certain taxpayers.

## WHAT INCOME IS SUBJECT TO THE INVESTMENT INCOME TAX?

**Annuity Contracts**

Perhaps the key aspect of the new Investment Income Tax for life insurance companies is the specific inclusion of "annuities" in the definition of "net investment income." It seems clear that the reference to annuities is not intended to reach the otherwise tax-deferred inside buildup of annuity contracts.[12] The definition refers to "gross income" from annuities (etc.), indicating that an item must be includible in gross income under existing tax law before it will be considered "net investment income" under the Act. Thus, only taxable distributions from annuity contracts would fall within the definition. For this purpose, section 61(a) provides that except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) annuities,[13] income from life insurance and endowment contracts,[14] and gains derived from dealings in property.[15] However, to the extent that another section of the Code or regulations provides specific treatment of any item of income, that other provision applies notwithstanding section 61 and the regulations thereunder.[16] To determine which amounts from an annuity are included in gross income, reference must be made to section 72.

*Annuity payments*. In particular, section 72(b)(1) provides that gross income does not include that part of any "amount received as an annuity" under an annuity contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date[17]) bears to the expected return under the contract (as of such date). In other words, section

72(b) provides rules to calculate an "exclusion ratio" for annuity payments received under an annuity contract once the contract is annuitized (*i.e.*, the value of the contract is applied to an annuity stream), subject to certain exceptions. The exclusion ratio operates to treat part of each annuity payment received as returning a portion of the contract holder's investment in the contract, with the remaining amount being includible in gross income. It is clear that this remaining amount, since it is includible in gross income, constitutes net investment income for purposes of the Investment Income Tax.

*Partial distributions*. Unless the reference to "annuities" in the definition of net investment income under the Investment Income Tax is limited to amounts received as an annuity under section 72(b), it is also necessary to consider the treatment of other income amounts from annuity contracts. In this regard, while the legislative history of the Act is silent on the matter,[18] the reference to annuities may be intended to sweep more broadly, encompassing all other amounts distributed from an annuity contract.[19] Since "annuities" as used in the Investment Income Tax is not defined for purposes of section 1411, the precise scope of the term is unclear.

Assuming that the broader reading of "annuities" was intended, the rules of section 72(e), which govern the tax treatment of amounts received under an annuity contract that are not received as an annuity, must be employed to determine the amounts of nonannuitized income that potentially are subject to the new tax. Generally, section 72(e)(2) provides that for distributions other than annuity payments (*i.e.*, "amounts not received as an annuity"), any amount received on or after the annuity starting date is included in gross income, and any amount received before the annuity starting date, other than in the case of a complete disposition (see below), is included in gross income to the extent that the income on the contract exceeds the investment in the contract.[20] Put differently, the entire amount of a distribution from an annuity contract that is not an annuity payment, but which is received after the annuity starting date, is included in gross income. Therefore, assuming the broader reading of the term "annuities" is used under the Investment Income Tax, that amount—a typical example of which is a policyholder dividend paid in cash—is fully included in the definition of net investment income for purposes of the new tax. And an amount such as a partial withdrawal that is received before the annuity starting date is included in net investment income to the extent it does not exceed the annuity's income on the contract (*i.e.*, it is taxed on an income-first basis).

*Loans, assignments and dividends*. The income-first tax treatment that applies to actual partial distributions from annuity contracts also applies to other types of amounts that provisions of the Code deem to be distributions. In particular, if an individual receives (directly or indirectly) any amount as a loan under an annuity contract, or assigns or pledges (or agrees to assign or pledge) any portion of the value of the contract, such amount or portion is treated as received under the contract as an amount not received as an annuity.[21] Furthermore, policyholder dividends are generally treated as amounts not received as an annuity, unless they are retained by the insurer as premiums or other consideration paid for the contract.[22] With regard to loans and dividends, the portion of the amount treated as received under the contract that is subject to the income-first rule will be includible in gross income, and as a result—again assuming the broader reading of the term "annuities"—that amount will be included in net investment income for Investment Income Tax purposes.

The exclusion ratio operates to treat part of each annuity payment received as returning a portion of the contract holder's investment in the contract. …

*Complete dispositions and transfers*. Any amount that is "not received as an annuity" and is received under an annuity contract either i) on the contract's complete surrender, redemption or maturity, or ii) in full discharge of the obligation under the contract and which is in the nature of a refund (whether paid in a single sum or otherwise), is includible in gross income to the extent that it exceeds the investment in the contract.[23] Further, if an individual transfers an annuity contract without full and adequate consideration (*i.e.*, a gratuitous transfer), the taxpayer must include in gross income the excess of the cash surrender value of the contract at the time of transfer over the investment in the contract at that time under the contract.[24] In each of these transactions, to the extent an amount is included in gross income pursuant to section 72, that amount presumably is included in net investment income for Investment Income Tax purposes under the broader reading of "annuities." Finally, in the case of an annuity contract that is transferred for valuable consideration (*i.e.*, a sale), gain is recognized under section 1001. While such gain may not be

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income from "annuities," it probably is encompassed within "net gain from dispositions of property," and on that basis it would be treated as net investment income for purposes of the new tax.

*Annuity distributions not subject to new tax*. Certain distributions from annuity contracts are not subject to the Investment Income Tax. As noted above, policyholder dividends retained by the insurer as premiums or other consideration paid for an annuity contract are not includible in gross income and, thus, are not subject to the new tax. Another instance of distributions from annuity contracts that are not included in gross income, and therefore are excluded from the Investment Income Tax, is that of amounts used to fund qualified long-term care insurance riders to annuity (and life insurance) contracts.[25]

One other category of income from annuity contracts that may not be subject to the new tax—the matter is not clear—is income described in section 72(u). That provision treats the inside buildup of an annuity contract held by a nonnatural person (*e.g.*, a corporation, partnership or trust) as currently includible in gross income, unless that person is holding the contract as an agent for one or more natural persons. Section 72(u) expressly declares that the contract held by a nonnatural person is not treated as an annuity for income tax purposes (except under subchapter L, the rules governing insurance company taxation). Hence, it would not seem logical to view the deemed income from such a contract as income from "annuities." That said, given the treatment of the contract prescribed by section 72(u), it is possible that the deemed income could fall under another category of receipt that makes up net investment income under the Investment Income Tax.

**Qualified Plans**

The definition of net investment income under the Investment Income Tax expressly excludes distributions from tax-qualified retirement plans, including IRA annuities. Specifically, section 1411(c)(5) provides that "net investment income" does not include any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Thus, distributions from an annuity contract that is an IRA, a section 403(b) annuity, or otherwise held as part of a tax-qualified retirement arrangement are not subject to the new tax, regardless of whether such distributions are periodic or nonperiodic. Presumably, however, such distributions (to the extent they are otherwise includible in gross income) are taken into account in determining whether a taxpayer has reached the income thresholds described above.[26] In that case, it might be advisable for an IRA annuity owner to examine the manner in which he or she will take the first required minimum distribution ("RMD").[27] More specifically, an IRA owner has until April 1 of the year following the year in which he or she turns age 70½ to take the first RMD, although the IRA owner must also take the second RMD for that year by December 31 of that same year. Depending on the IRA owner's income, two RMD payments in one year could cause that income to exceed the applicable income threshold. To avoid such a result, an IRA owner may want to take the first RMD in the year he or she turns age 70½ and not delay that distribution to the following year.

**Life Insurance Contracts**

While it is clear that the Investment Income Tax potentially applies to income from annuity payments, and it is possible that the tax also applies to other types of income from annuity contracts, it is less clear whether or how the new tax will apply to transactions involving life insurance contracts. The legislative history of the Act is silent on this point, and as noted above, section 61(a) distinguishes income from "annuities," referenced in paragraph 9 of the provision, from "income from life insurance and endowment contracts," referenced in paragraph 10. While the definition of net investment income under new section 1411 expressly includes annuities, it does not refer to income from life insurance or endowment contracts. On the other hand, in limited instances the term "annuities" has been defined or interpreted to include life insurance.[28] Section 1411 does, of course, include net gain from dispositions of property in net investment income for Investment Income Tax purposes.

In this regard, section 61(a)(3) generally treats gain from the disposition of property as includible in gross income, and sections 1001 *et seq.* specifically govern the tax treatment of such a disposition. In the case of a sale of a life insurance contract (*e.g.*, through a life settlement), it seems straightforward that income from such a sale is included in "net gains from the disposition of property" for Investment Income Tax purposes, for the simple reason that section 1001 applies to such a transaction.[29] In contrast, the disposition-of-property rule would not seem appropriately interpreted as including income from the surrender of a life insurance contract. The full or partial surrender of a life insurance contract generally is not treated as a disposition of property, in that such a transaction is governed by section 72 rather than by section 1001,[30] and nothing in the Act's language or legislative history expressly indicates the adoption of such an interpretation. Even so, absent guidance in the legislative history, there remains uncertainty as to how, if at all, the Investment Income Tax applies to transactions involving life insurance contracts.

## IMPACT IN THE MARKETPLACE

It will likely take some time before the effect of the new Investment Income Tax on the annuity marketplace is fully known. That said, several observations may be in order. First of all, the Act defines "net investment income" such that the phrase includes annuity payments (and maybe other distributions) from nonqualified annuity contracts along with dividends, interest, and net capital gains recognized in connection with mutual funds and individual stocks and bonds. Thus, one might think of the Act as imposing, for high income taxpayers, the same increase in the marginal income tax rate on annuity contract distributions as is imposed on dividends, interest, and net capital gains. To the extent that tax rates on annuity distributions and other types of investment income are being increased equally, the tax deferral provided by annuity contracts would appear relatively more attractive.

A second observation would be that a taxpayer seemingly would want to maximize the contributions to his or her qualified retirement plan, including an IRA annuity or Roth IRA annuity, instead of saving through other investment vehicles such as mutual funds. As described above, amounts distributed out of qualified retirement arrangements are not subject to the Investment Income Tax. Furthermore, the fact that Roth IRA distributions are not taken into account in determining whether a taxpayer exceeds the applicable income thresholds makes a Roth IRA one of the most advantageous products a taxpayer can invest in to minimize the application of the Investment Income Tax. High income taxpayers have been restricted in past years in the contributions they could make to qualified retirement plans, including IRAs, but to the extent such contributions have been made, the opportunity during 2010 to convert amounts to Roth IRAs regardless of income levels could provide additional benefit where the Investment Income Tax is concerned.

Third, and cutting in the opposite direction, it must be acknowledged that an increase in tax on annuity distributions will necessarily increase the "cost" of annuities for high income annuity owners. As a practical matter, however, this effect may be felt in relatively few households. A recent survey found that eight out of 10 nonqualified annuity owners have annual household incomes below $100,000, and only 4 percent have annual household incomes greater than $200,000.[31] The results of this survey indicate that many annuity owners would not have income in excess of the applicable thresholds and, thus, the new Investment Income Tax would not apply to annuity distributions received by them.

Finally, it may well be significant that the new Investment Income Tax is not effective until Jan. 1, 2013. This delay in the imposition of the tax gives the issuers and sellers of annuity contracts, along with the financial advisers of current and potential annuity owners, in excess of two years to work out sound strategies for addressing the impact of the new tax on retirement savings.

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END NOTES

1 Pub. L. No. 111-148.
2 Pub. L. No. 111-152.
3 Technically, the new 3.8% tax is labeled the "Unearned Income Medicare Contribution."
4 Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
5 A similar tax is imposed on estates and trusts. *See* section 1411(a)(2).
6 Section 1411(a)(1).
7 Section 1411(b)(1).
8 Section 1411(b)(2).
9 Section 1411(b)(3).
10 *See* section 62.
11 Section 1411(d).
12 *But see* the discussion of section 72(u) below.
13 Section 61(a)(9).
14 Section 61(a)(10).
15 Section 61(a)(3).
16 Treas. Reg. § 1.61-1(b).
17 *See* Treas. Reg. § 1.72-4(b)(1) (defining the annuity starting date as generally being the later of the date upon which the obligations under the contract became fixed or the first day of the period which ends on the date of the first annuity payment).
18 The relevant legislative history of the tax changes made by the Act appears in the *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act"* prepared by the Staff of the Joint Committee on Taxation (JCX-18-10, March 21, 2010). The Investment Income Tax is described on pages 134-136 of the document.
19 *See, e.g.,* section 3405(e)(1)(A) (treating any distribution from or under a commercial annuity as a designated distribution, which can be either a periodic payment (such as an annuity payment) or a nonperiodic distribution.
20 Section 72(e)(3) provides the rules for allocating amounts received before the annuity starting date to the income on the contract and to the investment in the contract.
21 Section 72(e)(4)(A).
22 *See* sections 72(e)(1)(B) and 72(e)(4)(B).
23 Section 72(e)(5)(E).
24 Section 72(e)(4)(C). Certain transfers between spouses or former spouses to which section 1041(a) applies (relating to transfers of property between spouses or incident to divorce) are not subject to this rule.
25 *See* section 72(e)(11).

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END NOTES (CONTINUED FROM PAGE 21)

[26] It appears that qualified distributions from Roth IRAs within the meaning of section 408A(d)(2) are not included in the taxpayer's income and therefore do not affect the taxpayer's income for purposes of determining whether the taxpayer exceeds the applicable income threshold under section 1411(b).

[27] *See* section 408(a)(6) and (b)(3) (requiring IRA owners to begin minimum distributions in accordance with the rules under section 401(a)(9) once they reach age 70½).

[28] *See, e.g.*, section 3405(e)(6) (defining a "commercial annuity" as an annuity, endowment or life insurance contract issued by an insurance company licensed to do business under the laws of any State); Treas. Reg. § 1.1244(c)-1(d)(vi) (providing that the term "annuities" means the entire amount received as an annuity under an annuity, endowment or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72).

[29] *See* Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (holding that sections 1001, 1011 and 1012 apply in determining the amount a taxpayer must recognize in gross income upon the sale of a life insurance contract).

[30] *See* section 72(e)(5)(E); Rev. Rul. 2009-13 (confirming that section 72 applies to amounts received under a life insurance contract, which would include amounts received upon complete surrender, redemption or maturity as well as partial withdrawals and policyholder dividends paid in cash).

[31] The Committee of Annuity Insurers, Survey of Owners of Non-Qualified Annuity Contracts (The Gallup Organization and Mathew Greenwald & Associates, 2009).