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# ACLI UPDATE COLUMN REGULATORY DEVELOPMENTS

By Mandana Parsazad, Pete Bautz and Walter Welsh

**A** CLI and its many members have been engaged with regulators on a host of issues as they have considered new guidance. The latter part of 2011 witnessed Treasury and Internal Revenue Service (IRS) release of guidance on (1) partial exchanges and partial annuitization of non-qualified annuity contracts, (2) life insurance and annuity contracts with long-term care (LTC) insurance features, and (3) exchanges of life insurance, annuity and LTC contracts for LTC insurance coverage. ACLI and its members also continued discussions with Treasury and IRS about the applicability of the Foreign Account Tax Compliance Act<sup>1</sup> (“FATCA”) to Life Insurance Companies and Products in response to Notices 2011-34 and 2011-53. We elaborate on these efforts below.

## PARTIAL EXCHANGES OF NON-QUALIFIED DEFERRED ANNUITY CONTRACTS

In June 2011, Treasury and IRS released new guidance on the federal tax treatment of partial exchanges of non-qualified deferred annuity contracts. Revenue Procedure 2011-38 supersedes Rev. Proc. 2008-24, prior guidance on this issue, and modifies many aspects of it.

Rev. Proc. 2008-24 treated the exchange of a portion of an annuity contract for a new contract as a tax-free exchange under section 1035 provided no amounts were withdrawn from, or received in surrender of, either of the contracts involved in the exchange within 12 months from the date of the exchange. Taxpayers demonstrating that one of the conditions described in section 72(q)(2)(A)-(C), (E), (F), (G), (H) or (J) “occurred between” the exchange date and withdrawal or surrender were excepted from the 12-month waiting requirement. Any subsequent withdrawal or surrender that did not meet these requirements voided the initial section 1035 exchange and made the entire transaction a taxable distribution. ACLI, in conjunction with the Committee of Annuity Insurers, sought clarification on this point and urged the government to consider conditions that would align partial exchanges with partial annuitizations, a position that was endorsed by legislators in the Small Business Jobs Act of 2010.



In Rev. Proc. 2011-38, the Treasury and IRS acknowledged some concerns caused by the “occurred between” requirement for the section 72(q)(2) exceptions, addressed the enactment of the Small Business Jobs Act of 2010 (which amended section 72 to clarify the rules for direct partial annuitization transactions), and modified prior guidance. For additional details on the guidance, please see *Partial Exchange Guidance Keeps Improving* in this issue of *TAXING TIMES*.

## LIFE INSURANCE AND ANNUITY CONTRACTS COMBINED WITH LONG-TERM CARE INSURANCE

In response to ACLI’s continued request for guidance, in August 2011, Treasury and IRS released Notice 2011-68<sup>2</sup> with interim guidance on annuity and life insurance contracts with LTC riders. The Notice specifically responded to the industry’s request for guidance on the tax treatment of basic policy transactions and also provided an opportunity for additional comments on issues identified by ACLI. For further discussion on these topics, we direct readers to the article *IRS Issues Guidance and Seeks Comments on LTC Insurance Product Issues* in this issue of *TAXING TIMES*.

In November 2011, ACLI submitted its comment letter in response to Notice 2011-68. Our comments identified issues of high priority for the industry and underscored the need for guidance on combination contracts as well as exchanges of life, annuity and LTC contracts for LTC coverage. We stressed the need for guidance on the effect of the payment of LTC insurance benefits on the investment in the contract so companies can develop and market new combination products. We also highlighted the need for guidance on exchange issues so own-

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**Mandana Parsazad** is senior counsel, Taxes & Retirement Security, at the ACLI in Washington, D.C. and may be reached at [MandanaParsazad@acll.com](mailto:MandanaParsazad@acll.com).

**Pete Bautz** is vice president, Taxes & Retirement Security, at the ACLI in Washington, D.C. and may be reached at [PeteBautz@acll.com](mailto:PeteBautz@acll.com).

**Walter Welsh** is executive vice president, Taxes & Retirement Security, at the ACLI in Washington, D.C. and may be reached at [WalterWelsh@acll.com](mailto:WalterWelsh@acll.com).

ers of life insurance and annuity contracts would be able to understand the tax consequences of exchanging life, annuity or LTC contracts for LTC insurance protection. Treasury and IRS have listed guidance on annuity/LTC combination contracts and exchanges of annuity contracts for LTC contracts on their 2011–2012 Priority Guidance Plan.

#### NOTICE 2011-34—APPLICABILITY OF FOREIGN ACCOUNTS TAX COMPLIANCE ACT (“FATCA”) TO LIFE INSURANCE COMPANIES AND PRODUCTS

FATCA, which requires increased disclosure of offshore accounts in order to improve tax compliance, was enacted as part of the Hiring Incentives to Restore Employment Act (“HIRE” Act) in March 2010. The provisions of FATCA impose a 30 percent withholding tax on payments to “foreign financial institutions” that do not comply with information reporting requirements with respect to financial accounts maintained by U.S. taxpayers in their institutions. FATCA is effective for payments made after Dec. 31, 2012.

In April 2011, Treasury and IRS issued a second Notice on FATCA: Notice 2011-34, a Supplemental Notice to Notice 2010-60,<sup>3</sup> that provided further guidance and requested additional comments on certain issues under chapter 4 subtitle A of the Code. Additional commentary on Notice 2011-34 is provided in *Notice 2011-53 Provides FATCA Transitional Relief*, included in this issue of *TAXING TIMES*. This Notice specifically asked whether insurance companies should undertake procedures similar to those outlined for private banking accounts with respect to holders of pre-existing individual accounts, including private placement life insurance (“PPLI”). ACLI submitted comments in response to Notice 2011-34 in July 2011, which addressed procedures outlined in the Notice for identification of U.S. accounts among pre-existing accounts. In particular, the letter suggested that any identification and reporting required for pre-existing accounts in Step 5 of the Notice be limited for life insurance products to so-called “PPLI products,” with all of the following characteristics:

- Cash values exceeding \$1,000,000;
- Enable policyholders to direct how the assets will be invested, and such direction is not limited to choosing from predefined funds offered to the public;
- Initial investment is through lump-sum premiums (later top-up premiums may be possible) of at least \$1,000,000;
- Assets belonging to the policy are managed in a bank or custodial segregated account for each separate policy (as

distinguished from other standard insurance products where assets are pooled with other assets of the insurer or assets of policyholders owning similar policies are commingled in separate or segregated accounts held for their benefit by the insurer);

- Allow policyholders to contribute assets other than cash to the segregated accounts; and
- Are not offered to the general public, *i.e.*, are sold only through private offerings.

We recommended a one-time electronic search of such policies for U.S. indicia meeting the criteria outlined above. We requested that all other pre-existing accounts that do not meet the criteria outlined above be exempted from chapter 4.

Our letter also included some preliminary observations in response to the timeline for implementation set forth in Notice 2011-53. In Notice 2011-53, Treasury and IRS acknowledged the legal and practical difficulties in implementing chapter 4. We requested that the timeline for life insurers be extended to allow for an opportunity to review and comment on detailed guidance specific to life insurance companies and products similar to those provided to financial institutions in Notices 2010-60, 2011-34 and 2011-53. We have also communicated general concerns that life insurers share with other corporations as payors and potential withholding agents, especially as parties to financial instruments and arrangements where the identity of the counterparty is unknown or changing.

Treasury and IRS have listed guidance and regulations to implement chapter 4 as an item on their 2011–2012 Priority Guidance Plan. ◀

#### END NOTES

<sup>1</sup> Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (the “HIRE”) Act.

<sup>2</sup> I.R.B. 2011-36 (Sept. 6, 2011).

<sup>3</sup> See also Frederic J. Gelfond and Mary M. Gillmartin, FATCA and Insurance: Fundamental Questions Remain Unanswered as Compliance Deadline Approaches, *TAXING TIMES*, Vol. 7 Issue 3 (Sept. 2011).