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ACLI UPDATE

BILL TO REQUIRE TAX REPORTING OF SALES OF INTERESTS IN LIFE INSURANCE POLICIES

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On March 14, the Senate passed S. 1813, the “Highway Investment, Job Creation, and Economic Growth Act of 2012” (“Highway Bill”) by a 74-22 vote. The bill contained a provision that requires tax reporting of sales of interests in life insurance policies. We understand the provision is identical to the bill introduced by Senator Robert Casey in January of this year. Senator Casey’s bill S. 2048, “A bill to amend the Internal Revenue Code of 1986 to clarify the tax treatment of certain life insurance contract transactions, and for other purposes” tracks very closely the legislative language the American Council of Life Insurers (ACLI) and its member companies developed over the past year and a half.

Senator Casey’s bill would require the buyer of an interest in a life insurance policy to report the sale to the Internal Revenue Service (“IRS”) and notify the life insurer that issued the policy. Upon notification of the sale by the purchaser, the life insurer is required to report the investment in the contract to the seller and the IRS. The insurer is also required to report the death benefit subsequently paid with respect to the life insurance policy.

Most notably, the Casey bill would amend section 1016 of the Internal Revenue Code by adding a subsection that would confirm the basis in the life insurance contract is not adjusted by cost of insurance charges. In Rev. Rul. 2009-13, the IRS concluded that the insured-seller’s basis in a life insurance contract should be adjusted by subtracting the cost of insurance charges from the investment in the contract. This bill would confirm the longstanding rule and the industry’s position that investment in the contract is not reduced for mortality, expense, or other reasonable charges incurred under the life insurance contract.

The fate of the Senate Highway Bill and its provisions is unknown as of the date of this article’s submission. The House may accept the Senate’s bill, amend it, or suggest a temporary extension of the current law. Federal funding for transporta-

tion projects will expire on March 31 unless a bill or an extension of the current funding is enacted by that date.

CHAIRMAN CAMP’S DISCUSSION DRAFT FOR A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

In October 2011, Ways & Means Chairman David Camp released a Discussion Draft for international tax reform that proposes a territorial system for taxation of international income (“Discussion Draft”). Chairman Camp asked specific questions on the content of the Discussion Draft and invited comments on how certain unaddressed issues should be treated in a territorial system.

Our member companies have been studying the various forms of territorial systems for taxing international income since February 2011 and assessing how life insurers might be affected. ACLI identified some key areas of concern for life insurers, including:

- Treatment of income related to active conduct of life insurance as active;
- Transition rules that unfairly penalize life insurance companies; and
- Increased complexity.

Based on this work, the ACLI prepared preliminary comments on Chairman Camp’s Discussion Draft. The ACLI letter addresses the treatment of income from the active conduct of life insurance business and some transitional issues that are important but not necessarily unique to life insurance companies.

Noting that the Discussion Draft does not change the rules for taxation of foreign personal holding company income under subpart F, and more specifically the rules for determining income derived in the active conduct of insurance

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business, ACLI observed that any reform should continue to exempt active financial service income from subpart F on a permanent basis. The parameters set for defining active life insurance income should take into full consideration the fact that a life insurance company's investment operations are an integral part of its life insurance business and its investment income is dedicated to the underwritten risks and obligations of that business.

ACLI also identified transitional issues raised by the Discussion Draft. These include:

- The effect of the 5.25 percent transition for industries that may only operate in per-se corporate form overseas;
- The tax treatment of proposed reclassification of foreign partnerships and branches as controlled foreign corporations;
- Exclusion of pre-acquisition earnings and profits when a taxpayer had not made a 338(g) election;
- Prospective application of the Discussion Draft's loss disallowance rule where losses are the result of business activity before the effective date of any new rules;
- Definition of earnings and profits for purposes of transitional rule; and
- Potential for double taxation of passive foreign income that is considered distributed under proposed section 245A of the Discussion Draft prior to the passage of this section's one-year holding period requirement.

ACLI staff and member company representatives are planning to meet with Ways & Means staff to share these preliminary comments on the Discussion Draft.

FOREIGN ACCOUNT TAX COMPLIANCE ACT ("FATCA")

The proposed regulations to implement the Foreign Account Tax Compliance Act ("FATCA"), enacted as part of the Hiring Incentives to Restore Employment Act,¹ were released by Treasury and IRS on Wednesday, Feb. 8. FATCA requires that "foreign financial institutions"² ("FFIs") obtain and report information with respect to any financial account which is held by a U.S. person. Failure to enter into an agreement with the Secretary of Treasury results in a 30 percent withholding tax on any U.S.-source withholdable payment to the FFI.³

ACLI and its member companies will be analyzing these proposed rules to identify the issues for life insurers and life

insurance products for comment and clarification. Below is a highlight of the proposed rules for life insurance companies and products.

The proposed regulations include life insurance companies as financial institutions for purposes of Chapter 4. Thus life insurance companies that issue life insurance or annuity contracts with any cash value would be financial institutions and subject to Chapter 4. ACLI requested that foreign life insurance companies that issue only life insurance contracts without cash value, such as all life reinsurance contracts, term life, return of premium, medical and disability, and other protection insurance policies, or issue contracts that fit the following criteria, not be treated as FFIs:

- \$50,000 or less in cash value;
- \$10,000 or less in annual premiums;
- Contracts for which the investment return does not exceed the premiums and other amounts paid for the contract during the first 10 years;
- Contracts with death benefits of \$500,000 or less.

The proposed regulations exclude pre-existing and newly issued term life insurance from the definition of a financial account.⁴ The Detailed Descriptions of the proposed regulations explain that "insurance contracts that provide pure insurance protection (such as term life, disability, health, and property and casualty insurance contracts)" are excluded from the term financial account. ACLI requested that life insurance or annuity contracts without cash value, all life reinsurance contracts, term life, return of premium,⁵ medical and disability, and other protection insurance policies should not be treated as financial accounts as they present no tax evasion risk. The proposed regulations do not specifically address life reinsurance.

The proposed regulations also exclude pre-existing and newly issued retirement or pension accounts from the definition of a financial account. ACLI requested that retirement plans be exempted from FATCA because they pose a low risk of tax evasion.

The proposed regulations exclude from the due diligence procedures pre-existing life insurance and annuity contracts with cash values of \$250,000 or less. For these pre-existing accounts, the foreign financial institution will be required to perform due diligence when the account balance or value ex-

ceeds \$1,000,000.⁶ For pre-existing life insurance and annuity contracts with cash values of \$250,000 and more, the rules require the foreign life insurance company to conduct an electronic search of their files for indicia of U.S. policyholders. For policies with cash values in excess of \$1,000,000, a manual search of the files for indicia of U.S. policyholders is required. Also, actual knowledge of U.S. taxpayer status by a relationship manager associated with the account must be included in the review of these accounts.

The proposed regulations define financial account to include any life insurance or annuity contract with cash values above zero as subject to Chapter 4 reporting.⁷ They define cash value as: “the greater of—

1. The amount that the policyholder is entitled to receive upon surrender or termination of the contract (determined without reduction for any surrender charge or policy loan); and
2. The amount the policyholder can borrow under or with regard to the contract.”⁸

ACLI requested de minimis exceptions and advocated for the use any of the following criteria to exclude newly issued contracts from Chapter 4 requirements:

- \$50,000 or less in cash value,
- \$10,000 or less in annual premiums,
- Investment returns that do not exceed the premiums and other amounts paid for the contract during the first 10 years; or
- Death benefit of \$500,000 or less.

We continue to consider a need for a de minimis rule and a more appropriate definition of cash value.

Finally, ACLI 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. ◀

END NOTES

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

² Sections 1471(d)(5), 1471(a) and (b).

³ Withholdable payments are defined in section 1473(1) as “any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic gains, profits, and income, if such payment is from sources within the United States, and ... any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.”

⁴ Prop. Treas. Regs. §1.1471-5(b)(2)(ii).

⁵ Contracts may provide for returning of a portion of the premium up to 100 percent of the premium.

⁶ Prop. Treas. Regs. §1.1471-4(c)(4)(iv).

⁷ Prop. Treas. Regs. §1.1471-5(b)(3)(v). The definition of “custodial accounts” also includes insurance or annuity contract. See, Prop. Treas. Regs. §1.1471-5(b)(3)(ii).

⁸ Prop. Treas. Regs. §1.1471-5(b)(3)(v)(B).

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