SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2013 – Volume 9 Issue 2

6. Revenue Ruling on the determination of the company's share and policyholder's share of the net investment income of a life insurance company under I.R.C. § 812. (This has been the same for the last several years, except a "Revenue Ruling" has been substituted for the more general term "Guidance" used earlier.)

7. Guidance clarifying whether the CTE Amount computed under AG 43 should be taken into account for purposes of the Reserve Ratio Test under I.R.C. § 816(a) and the Statutory Reserve Cap under I.R.C. § 807(d)(6). (This is a new project; see discussion above.)

8. Regulations under I.R.C. § 833 to establish the method to be used by Blue Cross Blue Shield entities in determining the medical loss ratio required by that section. (This is a new project and addresses an issue for health insurance companies from the Affordable Care Act of 2010.)

9. Guidance on exchanges under I.R.C. § 1035 of annuities for long-term care insurance contracts. (This was on the 2011–2012 Plan.)

10. Regulations under I.R.C. § 7702 defining cash surrender value. (This has been the same for the last several years.)

While the 2012–2013 Priority Guidance Plan includes the CTE Amount project, there is no project on principle-based reserves (PBR) for life insurance contracts as requested by the ACLI. However, even if the ACLI's request for a life PBR project may have been declined (*e.g.*, because the rules are not yet required for tax purposes), IRS Insurance Branch representatives have indicated that life PBR issues are still being actively considered.

Other projects included in the 2012–2013 Priority Guidance Plan that are not directed to, but may be of interest to, life insurance companies are:

• Financial Institutions and Products—Guidance addressing the character and timing of hedge gains and losses for purposes of I.R.C. § 1221 and Treas. Reg. § 1.446-4 for hedges of guaranteed living benefits and death benefits provided with regard to variable annuities. (This was on the 2011–2012 Plan.)

• General Tax Issues—Final regulations under I.R.C. § 7701 regarding Series LLCs and cell companies. Proposed regulations were published on Sept. 14, 2010. (This is a new project.)

• International Issues (Inbound Transactions)—Regulations under I.R.C. § 882 regarding insurance companies. (This is a new project.)

• Tax Accounting—Regulations under I.R.C. § 453 addressing certain annuity contracts received in exchange for property. (This has been on the Guidance Plans for the last several years.).

END NOTES

[1] 2010-15 I.R.B. 547.

[2] Apparently the 2001 CSO mortality table project is not intended to include a reconsideration of the analysis in PLR 201230009 (Jan. 30, 2012), which surprised the industry by concluding that a reduction in death benefit would cause a life insurance contract to be "newly issued" for purposes of the safe harbors provided in § 5 of Notice 2006-95, 2006-2 C.B. 848, for satisfying the reasonable mortality charge requirements of I.R.C. § 7702(c)(3)(B)(i).

[3] 2011-36 I.R.B. 205.

[4] 2013-14 I.R.B. 743.

APPLYING SECTION 72(S) TO JOINT-LIFE GLWBS COVERING NON-SPOUSES

By Alison R. Peak, Bryan W. Keene and Joseph F. McKeever

In January, the Internal Revenue Service ("IRS") released PLRs 201302015 and 201302016, which address how section 72(s) applies to a deferred annuity that has a guaranteed lifetime withdrawal benefit ("GLWB") rider covering the joint lives of the owner and a non-spouse beneficiary.[1] Section 72(s) requires certain distributions to be made from a non-qualified annuity after the owner dies.[2] If the beneficiary is the owner's surviving spouse, however, the contract can continue without section 72(s) requiring any distributions until the spouse dies.[3] In the two recent rulings, the contract issuer proposed a "New Distribution Option" that would allow a *non-spouse* beneficiary to continue the contract—and thus the GLWB coverage—after the owner's death, without requiring any distributions from the contract. The rulings conclude that this will comply with section 72(s). The key to the conclusion was that the New Distribution Option caused the contract's death benefit to be immediately taxable to the non-spouse beneficiary as if he had received it, even though

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Alison R. Peak is an associate with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *arpeak@davis-harman.com.*

Bryan W. Keene is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *bwkeene@davis-harman.com.*

Joseph F. McKeever is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jfmckeever@davis-harman.com.*

no distribution would actually be made from the contract. Thus, the non-spouse beneficiary could continue the contract and its existing GLWB coverage, but not its prior tax deferral, following the owner's death.

FACTS

The contracts involved in the rulings are non-qualified, deferred variable annuities. If the owner dies before the annuity starting date, the named beneficiary can elect to receive a death benefit under one of three options that complies with section 72(s), *e.g.*, within five years of the owner's death. The contracts also include GLWB riders that operate in the typical fashion. For example, they guarantee a minimum withdrawal amount for the life of the owner or the joint lives of the owner and a beneficiary, but if withdrawals in excess of the guaranteed amount are taken, future guaranteed amounts are reduced or eliminated.

The rulings explain that section 72(s) can create an issue for a GLWB covering the joint lives of an owner and non-spouse beneficiary. If the owner predeceases the non-spouse beneficiary, a death benefit becomes payable under one of the contract's existing, section 72(s)-compliant distribution options, such as a full distribution within five years. Such distributions would likely exceed the guaranteed minimum withdrawal amount, thereby reducing or eliminating future GLWB coverage, even though the coverage was intended to continue for the joint lives of the owner and the non-spouse beneficiary. The New Distribution Option aims to address this problem.

Under the New Distribution Option, the contract and GLWB rider would continue after the owner's death with the non-spouse beneficiary as the new owner, but without any actual distributions being triggered by the owner's death. Thus, there would be no forced "excess withdrawal" that would reduce future GLWB coverage. However, the New Distribution Option would require the non-spouse beneficiary to include in his gross income the amount that would have been taxable to him had he instead elected to completely surrender the contract for its death benefit. In that regard, the beneficiary would be required to "affirmatively and irrevocably decline the existing distribution options" by signing an election form. The form would state that (1) the beneficiary will not actually receive a death benefit payment but will be treated as receiving one for tax purposes, and (2) the contract issuer will send the non-spouse beneficiary a Form 1099-R reporting the gross and taxable amounts of the death benefit that he will be treated as having received as a result of electing the New Distribution Option.

The discussion of applicable law and the analysis in the rulings are brief. They restate the applicable portion of the section 72(s) requirements and then observe that:

> Examination of the text and purpose of § 72(s) indicates an intent that the entire interest of non-qualified annuity contracts be distributed within certain periods following the death of the holder in order to prevent additional tax deferral. We see no indication that § 72(s) prevents the non-spouse beneficiary of a non-qualified annuity contract holder from electing to be treated for tax purposes as if he or she had received that entire interest.

The rulings then conclude that the New Distribution Option will satisfy the requirements of section 72(s).

OBSERVATIONS

The rulings present an approach to applying section 72(s) that is not reflected in any prior IRS rulings. Based on the premise that section 72(s) is meant to limit tax deferral beyond the contract owner's death, the IRS seems to reason that as long as the deferral ends within the required time frame, section 72(s) is satisfied irrespective of whether any amount is *actually* distributed from the contract.

In that regard, we note that a cash basis taxpayer is generally taxed only on amounts that she actually or constructively receives, so a mere election to include an amount in income—absent actual or constructive receipt of that amount—would be insufficient to make it taxable.[4] Because the New Distribution Option does not result in the *actual* receipt of the death benefit, it presumably must result in its *constructive* receipt. Although the rulings do not delve into why (or even whether) electing the New Distribution Option results in constructive receipt, one reason might be that the non-spouse beneficiary must "affirmatively and irrevocably decline the existing distribution options" in order to elect the New Distribution Option. Having declined the existing distribution options, there is nothing standing between the non-spouse beneficiary and the death benefit other than a simple request for the money.

In sum, the rulings present an interesting means of complying with section 72(s) in circumstances where

neither the insured nor the beneficiary wants the contract to terminate by virtue of an actual distribution. This approach would seem to be particularly helpful in the context of GLWB riders covering the joint lives of two individuals who are not spouses, *e.g.*, siblings, couples who live together but choose not to marry, and same sex couples who may be partners to a civil union or enjoy status as spouses under state law but not federal law.[5]

END NOTES

[1] The rulings were issued on July 13, 2012, and were released to the public on Jan. 11, 2013. The rulings appear to have been issued to affiliated life insurance companies.

[2] Section 72(s) distributions are triggered by the death of any contract "holder," which generally means any owner. If an owner dies on or after the annuity starting date, any remaining interest in the contract must be distributed at least as rapidly as the method of distribution being used on the date of death. Section 72(s)(1)(A). If an owner dies before the annuity starting date, any remaining interest in the contract must be distributed within five years of the owner's death or over the life or life expectancy of a designated beneficiary starting within a year of the owner's death. Section 72(s)(1)(B) and (2).

[3] Section 72(s)(3).

[4] *See* Treas. Reg. section 1.451-1(a).

[5] *See* Defense of Marriage Act, 1 U.S.C. § 7 (defining "spouse" for purposes of federal law as "a person of the opposite sex who is a husband or a wife").

APPLYING SECTION 1035 TO A POST-DEATH EXCHANGE OF A SECOND-TO-DIE LIFE CONTRACT

By Mark E. Griffin

In January, the Internal Revenue Service (IRS) released PLR 201304003, which addressed the application of section 1035 to the exchange of a survivorship, or "second-to-die," life insurance contract after the death of one of the insureds for a new life insurance contract covering only the life of the surviving insured.[1] Section 1035(a)(1) provides that no gain or loss will be recognized on the exchange of a "contract of life insurance" for another "contract of life insurance." In addition, the regulations state, in part, that section 1035 does not apply "if the policies exchanged do not relate to the same insured."[2] As explained below, the IRS in PLR 201304003 concluded that the exchange satisfied this "same insured" requirement in the regulations and qualified for nonrecognition treatment under section 1035.

FACTS

A husband and wife (A and B) purchased a second-to-die life insurance contract (Old Policy), which provided for the payment of a death benefit equal to a specified amount ($X) upon the death of whichever spouse was the last to die. Old Policy was a life insurance contract under sections 1035(b)(3) and 7702. The couple transferred the contract to an irrevocable trust that they established (Old Trust).

One spouse (A) later died, leaving the surviving spouse (B) as the sole insured under Old Policy. B subsequently transferred Old Policy to a new irrevocable trust (New Trust) settled by B, with the consent of all the beneficiaries of Old Trust, in accordance with the requirements of state law. New Trust was the owner and sole beneficiary of Old Policy.

The trustee of New Trust exchanged Old Policy for a new life insurance contract (New Policy) under which New Trust was the owner and sole beneficiary, B was the sole insured, and the death benefit was equal to $Y. New Policy was a life insurance contract under sections 1035(b)(3) and 7702. The exchange was accomplished by New Trust assigning its interest in Old Policy to the issuer of New Policy, the new issuer issuing New Policy to New Trust, and the new issuer then surrendering Old Policy.

ANALYSIS AND CONCLUSION

In applying section 1035 to the exchange of Old Policy for New Policy, the IRS in PLR 201304003 considered (1) whether Old Policy and New Policy were life insurance contracts to which section 1035 applied, and (2) whether the exchange was one which qualified for nonrecognition treatment under that section.

- The IRS indicated generally that in order for Old Policy and New Policy to be contracts subject to section 1035, they must satisfy both section 7702 (which defines a "life insurance contract" for purposes of the Internal Revenue Code) and section 1035(b)(3) (which defines a "contract of life insurance" for purposes of section 1035).[3] Based on representations made by New Trust, the IRS was comfortable that Old Policy and New Policy satisfied these sections.

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