



SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2013 – Volume 9 Issue 2



1	Proposed Guidance on the New Net Investment Income Tax on “Annuities” By John T. Adney and Alison R. Peak
2	From the Editor To Our Readers By Christian DesRochers
4	From the Chair Where Would We Be Without Volunteers? By Mary Elizabeth Caramagno
10	Erroneous Tax Reserve Computations—Year of Correction By Peter H. Winslow
13	IRS Releases New Ruling on BOLI Partnership By John T. Adney and Bryan W. Keene
16	Are Reserves for Bad Faith Claims Deductible by a Life Insurance Company? By Peter H. Winslow
19	American Taxpayer Relief Act of 2012—Active Financing Income Exception to Subpart F By James A. Sabella and Edward Clabault
22	ACLI UPDATE Deficiency Reserve Guidance By Walter Welsh, Mandana Parsazad and Pete Bautz
26	T³: TAXING TIMES Tidbits

PROPOSED GUIDANCE ON THE NEW NET INVESTMENT INCOME TAX ON “ANNUITIES”

By John T. Adney and Alison R. Peak

As part of the health care legislation enacted in March of 2010, Congress added new section 1411 to the Internal Revenue Code,¹ imposing a 3.8 percent tax on certain types of “net investment income” of high income taxpayers beginning this year (referred to herein as the “Investment Income Tax” or the “new tax”). As described more fully below, the Investment Income Tax applies to, among other things, gross income from “annuities” as well as from certain dispositions of property. On Nov. 30, 2012, the Department of the Treasury and the Internal Revenue Service (“IRS”) published proposed regulations explaining the application and scope of the new tax.² In this article, we briefly review the background and history of the new tax and then describe and examine in detail the proposed regulations and how they affect taxpayers holding annuity and life insurance contracts.

BACKGROUND & HISTORY

The Health Care and Education Reconciliation Act of 2010 added section 1411 to the Code effective for taxable years beginning after Dec. 31, 2012.³ For additional background on this new provision and the manner in which it was enacted, we refer you to our September 2010 *TAXING TIMES* article, “Tapping a New Revenue Source—Congress Expands the Medicare Tax Base to Include Income from ‘Annuities.’”

As noted above, the new provision imposes a 3.8 percent tax on certain types of “net investment income” of taxpayers with higher incomes—technically, those who have “adjusted gross income” exceeding thresholds specified in the provision. More specifically, the tax applies to the lesser of (A) an individual’s “net investment income” for a year, or (B) the individual’s (i) “modified adjusted gross income” (“MAGI”) for the year, over (ii) the “threshold

CONTINUED ON **PAGE 5**

amount.”⁴ MAGI is adjusted gross income, as that term is generally defined,⁵ 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).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. Taxpayers with MAGI at or below the applicable income threshold are not subject to the tax, irrespective of their net investment income.

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 non-investment business), minus (4) otherwise allowable deductions properly allocable to the foregoing. Hence, the new tax essentially aims to capture passive-type income items in its base, less certain deductions allocable to such income.

As we discussed in our September 2012 *TAXING TIMES* article, the new law raises questions regarding how section 1411 applies to insurance products. There have been questions, for example, as to the interpretation of the term “annuities.” That term generally is not used in section 72, which contains the principal rules governing the income tax treatment of distributions from annuity contracts and pre-death distributions from life insurance contracts. The term does appear, however, elsewhere in the Code. For example, it appears in the section 61 list of the kinds of receipts generally includible in gross income (where it is listed separately from life insurance and endowment contract income) and also in sections 1441(b) (relating to the withholding of tax on nonresident aliens) and 6041(a) (defining the so-called “FDAP” income subject to withholding at source). In our prior article we explained why “gross income from ... annuities” most likely would not encompass the undistributed “inside buildup” of annuity and life insurance contracts. This conclusion followed from the fact that the new tax applies only to amounts that constitute gross income, and the inside buildup is not even potentially includible in gross income until there has been a distribution from (or sale of) a contract.

On the other hand, we said in our prior article that we thought that “amounts received as an annuity” under annuity contracts—the amounts includible in gross income after applying the exclusion ratio under section 72(b)—clearly constitute investment income for purposes of the Investment Income Tax. At the same time, we were less certain that “gross income from ... annuities” encompasses other distributions from an annuity contract, *i.e.*, “amounts not received as an annuity” under section 72(e). For example, we considered whether income from “annuities” would include partial distributions, loans, assignments, and dividends from annuity contracts, which amounts are generally includible in income to the extent of any income on the contract (and includible in full if received after the annuity starting date) as provided in the section 72(e) rules.

In our prior article, we were able to conclude that *some* distributions from annuity contracts likely would not be subject to the Investment Income Tax. For example, dividends retained by the insurer as premiums or other consideration paid for an annuity contract, which would include excess interest and earnings credits, are not includible in gross income and thus are not subject to the new tax. The rule in section 72(e)(4)(B) makes this clear. In addition, by virtue of section 72(e)(11), deemed distributions from annuity contracts to fund qualified



CONTINUED ON PAGE 6

long-term care insurance riders on such contracts do not constitute gross income, and thus they should not be viewed as gross income from “annuities” for purposes of the new tax. And, of course, qualified plan distributions are excluded from the base of the Investment Income Tax pursuant to the express rule in section 1411(c)(5).

Apart from the above, we noted that because distributions from life insurance and endowment contracts also are taxed under section 72, there could be questions about whether, or to what extent, the Investment Income Tax would apply to pre-death distributions from such contracts. Subsequently to the publication of our prior article, we have also encountered questions about whether the new tax would be accompanied by additional tax withholding and reporting requirements.¹⁰

PREAMBLE & PROPOSED REGULATIONS

When the Treasury Department and the IRS published proposed regulations last November on the application of the Investment Income Tax, the Notice of Proposed Rulemaking confirmed the conclusions and answered a number of the questions we noted in our prior article. Interestingly, however, the proposed regulations do not themselves provide a definition of “gross income from ... annuities” or explain how annuity and life insurance contracts should be treated for purposes of calculating net gain from the disposition of property. Rather, it is the preamble to the proposed regulations (the “Preamble”) that sheds light on some of the issues that we identified in our prior article. Accordingly, we now proceed to summarize below the Preamble’s description of how the Investment Income Tax applies to insurance contracts.

Gross Income from “Annuities.” The Preamble states that “[g]ross income from annuities includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e).” Based on the Preamble, the term “annuities” includes amounts received as an annuity, *i.e.*, annuitized payments, under not only an annuity contract but also a life insurance or endowment contract. However, with respect to amounts “not received as an annuity,” the term “annuities” is more limited according to the Preamble, encompassing within the Investment Income Tax base only distributions under an annuity contract, and only to the extent they are includible in gross income pursuant to section 72(e). In other words, the new tax does not apply to the taxable portion of a withdrawal or other non-periodic

distribution from a life insurance contract (including a modified endowment contract as defined in section 7702A) or an endowment contract. On the other hand, the new tax will apply to the taxable portion of *any* distribution from a non-qualified annuity contract, whether periodic or non-periodic. The exclusion of non-periodic distributions from life insurance and endowment contracts makes sense, since such distributions are not generally considered gross income from “annuities.”

The Preamble confirms that amounts paid from annuity contracts that are includible in income pursuant to section 72(e), such as dividends, loans, and assignments, are included in the calculation of net investment income. In addition, it is clear from the Preamble that dividends retained by the insurer as premiums or other consideration paid for an annuity contract, and distributions from a contract to pay for a qualified long-term care insurance rider, are not treated as gross income from annuities because such amounts are not includible in income under section 72(e). Moreover, the Preamble confirms by implication that the Investment Income Tax does not apply to the undistributed inside buildup under an annuity, life insurance, or endowment contract.

Dispositions of Property. Section 1411(c)(1)(A)(iii) provides that net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property is also treated as net investment income for purposes of the Investment Income Tax. Thus, gain from the sale of an annuity or life insurance contract could be includible in net investment income. In the context of annuity contracts, the Preamble sets forth a rule allocating the gain from an annuity contract sale between “gross income from annuities” and net gain attributable to the disposition of property. In particular, it provides that to the extent the sales price of the annuity contract does not exceed the contract’s surrender value, the net gain recognized (the sale proceeds less the seller’s basis in the annuity) would be treated as gross income from annuities. If the sales price of the contract exceeds its surrender value, the seller would treat (1) the gain equal to the difference between the basis in the annuity and the surrender value as “gross income from annuities,” and (2) the excess of the sales price over the surrender value as net gain from the disposition of property. In essence, the portion of the sales proceeds that does not exceed the contract’s surrender value will be taken into account in determining gross income from annuities, and any excess of the sales proceeds over the surrender value will be taken into account as net gain from the sale or disposition of property.¹¹ Both amounts, however, will be subject to tax at the same 3.8 percent rate.

Example. Assume that taxpayer owns an annuity contract with basis (or, investment in the contract) of \$80 and a “surrender value” of \$90. Assume further that taxpayer sells the contract for \$100. Under the allocation rule described in the Preamble, the taxpayer would first allocate \$10 (\$90 surrender value - \$80 basis) to “gross income from annuities.” The taxpayer would allocate the remaining \$10 (\$100 sales price - \$90 surrender value) to “net gain from the disposition of property.”

An initial question regarding this allocation rule for annuity contracts is whether, as used in the Preamble, “surrender value” is intended to be a contract’s cash value after the imposition of surrender charges and “basis” is intended to equal the contract’s section 72(e)(6) “investment in the contract.” Notably, the Preamble provides that “other than [certain] specific cross-references to provisions of chapter 1, and certain specific definitions set forth in section 1411, section 1411 does not provide definitions of its operative phrases or terminology. Moreover, there is no indication in the legislative history of section 1411 that Congress intended, in every event, that a term used in section 1411 would have the same meaning ascribed to it for other Federal income tax purposes (such as chapter 1).” After this warning, however, the Preamble goes on to observe that “[u]nder these proposed regulations, except as otherwise provided, chapter 1 principles and rules [which include section 72] apply in determining” the application of the new tax. The Preamble thus leaves somewhat unclear whether the terms “cash surrender value” and “investment in the contract” as used in section 72 would apply for purposes of determining a contract’s “surrender value” and “basis,” respectively, for purposes of the Investment Income Tax.

While the Preamble does not address the disposition of life insurance contracts, seemingly a sale of a life insurance contract is treated as a disposition of property for purposes of section 1411(c)(1)(A)(iii). Although the Preamble’s allocation rule for the sale of an annuity contract by its terms does not extend to a disposition of a life insurance contract, it would appear that the rules for determining gain or loss on the sale of a life insurance contract should apply to determine net gain on the disposition of property (as we discussed in our prior article).¹² This would seem to have the same result as if the allocation rule for annuities did apply, based on the published guidance regarding life insurance sales.¹³

Losses on Annuity Contracts. Another question that could arise under the proposed regulations is whether or how losses

on annuity contracts are reflected in the new tax. In certain cases, section 165 allows taxpayers to deduct losses on the surrender or sale of an annuity contract, subject to the 2 percent adjusted gross income floor.¹⁴ In addition, section 72(b)(3) provides a deduction in certain cases where annuity payments cease before the taxpayer recovers his or her full investment in the contract. The Preamble and proposed regulations are not clear on how (or if) these deductions are taken into account when calculating net investment income. For example, they provide generally that loss deductions under section 165 can be taken into account only for purposes of determining net gain from the disposition of property, with the apparent implication that such loss deductions do not reduce “gross income from interest, dividends, annuities, royalties, and rents.”¹⁵ Moreover, the proposed regulations set forth what appears to be an exclusive list of specific deduction items that can be used to offset gross income from annuities, etc., but that list does not include section 72(b)(3).¹⁶ Of course,

The FAQs state that the new tax is not subject to wage withholding, but they point out that taxpayers can request that additional amounts be withheld from their wages.



CONTINUED ON PAGE 8

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com.

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.

if a taxpayer with MAGI above the applicable threshold owns but a single investment that is an annuity contract, no particular harm would arise if a loss on the contract could not be reflected in the calculation. However, it would seem that in most cases a taxpayer who incurs a loss on an annuity transaction also would have other investment income. It is in those cases that the proposed regulations lack clarity on how losses should be treated. Because the new tax purports to be one on “net” investment income, there should be some ability to reflect losses on annuity transactions, given that income from annuities is includible in the gross income base.

Withholding and Reporting. In connection with the publication of the proposed regulations on the Investment Income Tax, the IRS published some Frequently Asked Questions on section 1411 (“FAQs”).¹⁷ The FAQs address, among other topics, whether additional wage withholding will be required as a result of the Investment Income Tax. This is relevant to insurance companies because the wage withholding rules generally apply to periodic distributions from insurance contracts pursuant to section 3405(a). The FAQs state that the new tax is not subject to wage withholding, but they point out that taxpayers can request that additional amounts be withheld from their wages.¹⁸ In addition, although not discussed in the FAQs, the legislation that enacted section 1411 did not amend the existing Code provisions applicable to the 10 percent withholding tax on non-periodic distributions from insurance contracts pursuant to section 3405(b). Accordingly, it appears that insurers can continue applying the withholding rules under current law to designated distributions they make under the contracts they issue. On the other hand, in late February one change appeared in the applicable tax reporting instructions. According to page 1 of the instructions for the 2013 Form 1099-R, reporting payors must “[u]se Distribution Code D to identify nonqualified annuity payments that may be subject to tax under section 1411.” This code is to be reported in box 7 of the form.

Qualified Plans. Section 1411(c)(5) provides that net investment income “shall not include any distribution from a plan

or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b).” The proposed regulations, along with the Preamble, confirm that net investment income does not include distributions from qualified retirement plans, IRAs, and section 457(b) plans. The proposed regulations provide examples on a variety of situations in which such distributions are not treated as net investment income subject to the new tax, including rollovers, deemed distributions and corrective distributions of excess contributions, and Roth conversions. The Preamble notes, however, that taxable qualified plan distributions are included in the taxpayer’s MAGI for purposes of applying the thresholds.

Effective Date. The Treasury and the IRS have requested comments on the proposed regulations and have scheduled a public hearing. According to the Preamble, the agencies intend to finalize the regulations this year. The proposed regulations would generally be effective for taxable years beginning after Dec. 31, 2013, although section 1411 is already effective, applying for taxable years beginning after Dec. 31, 2012. In this regard, the Preamble states that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Interestingly, the Notice of Proposed Rulemaking and the FAQs say nothing about relying on the Preamble itself, leaving taxpayers and insurers with some question about the degree of comfort (or not) that they can take away from the guidance.

CONCLUSION

The proposed regulations and, more specifically, the Preamble endeavor to provide some clarification as to the application of the Investment Income Tax to contracts issued by life insurers. They furnish responses to a good many questions that life insurers have had regarding the scope of gross income from “annuities,” although, as is often the case with formal guidance, some questions remain open. Life insurers have learned to live with a relative paucity of guidance when it comes to the federal tax treatment of their products, and so reading and attempting to follow observations made in the Preamble rather than specific regulatory rules will not be a new experience for them. ◀

END NOTES

- ¹ References to “section” are to sections of the Internal Revenue Code of 1986, as amended (“Code”).
- ² 77 Fed. Reg. 72612 (Dec. 5, 2012). The government released an advance version of the proposed regulations on Nov. 30, 2012, and the official version was published in the Federal Register five days later.
- ³ Pub. L. No. 111-152, § 1402(a)(1).
- ⁴ Section 1411(a)(1).
- ⁵ See section 62.
- ⁶ Section 1411(d).
- ⁷ Section 1411(b)(1).
- ⁸ Section 1411(b)(2).
- ⁹ Section 1411(b)(3).
- ¹⁰ See section 3405.
- ¹¹ This division is comparable to the one set forth in Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, in the case of the sale of a life insurance contract.
- ¹² See Rev. Rul. 2009-13, *supra* note 11 (holding, *inter alia*, 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).
- ¹³ See *id.*
- ¹⁴ See IRS Pub. 575, Pension and Annuity Income, at 22 (2012) (a “loss under a nonqualified plan, such as a commercial variable annuity, is deductible...”).
- ¹⁵ See Prop. Treas. Reg. § 1.1411-4(f)(4) (stating that the allowable deductions “do not include losses described in section 165, whether described in section 62 or section 63(d). Losses deductible under section 165 are deductible only in determining net gain under paragraph (d) of this section, and only to the extent of gains.”)
- ¹⁶ We note that one deduction item that the list does include is section 62(a)(9). See Prop. Treas. Reg. § 1.1411-4(f)(2)(iii). Section 62(a)(9) provides above-the-line treatment for certain loss deductions under section 165 that otherwise would be miscellaneous itemized deductions (specifically, certain losses relating to early withdrawal fees on CDs and similar timed deposits). Because section 62(a)(9) merely changes the status of a section 165 deduction, its inclusion in the list of allocable deduction items under the proposed regulations would appear to run contrary to the general rule, described above, that prohibits the use of section 165 deductions for any purpose other than calculating “net gain” from dispositions of property.
- ¹⁷ See <http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs>.
- ¹⁸ Under current law the wage withholding rules allow a taxpayer to elect a dollar amount to be withheld in addition to the amount of withholding based on filing status and withholding allowances claimed on IRS Form W-4, *Employee’s Withholding Allowance Certificate*.

Three RESERVES SEMINARS

Society of Actuaries and **PolySystems** are bringing you to the loop—Chicago’s “Loop”—and keeping you “in the loop” on the latest U.S. reserving principles.

Traditional Life Insurance

JUNE 5, 2013

Universal Life Insurance—Fixed, Indexed and Variable

JUNE 6, 2013

Deferred Annuities—Fixed, Indexed and Variable

JUNE 7, 2013



Register today at www.soa.org/calendar.