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TAXATION SECTION SESSIONS AT THE LIFE AND ANNUITY SYMPOSIUM

By Christian DesRochers

The Taxation Section sponsored three sessions at the Life and Annuity Symposium in Toronto, Ontario on May 6 and 7, 2013. Following the symposium, the section sponsored a seminar titled "Internal Revenue Code Sections 7702 and 7702A: Introduction to the Tax Rules Affecting Life Insurance Products."

039 PD—PRODUCT TAX UPDATE

Brian G. King, FSA, MAAA, EY

Craig R. Springfield, JD, Davis & Harman LLP

In their session, Brian King and Craig Springfield covered a variety of topics related to the taxation of life insurance and annuity contracts. Among the topics covered were product tax items on the Internal Revenue Service (IRS) Priority Guidance Plan, including guidance on annuity contracts with a long-term care (LTC) rider under Section 72 and 7702B, guidance on exchanges of annuities for long-term care insurance under Section 1035 and regulations under Section 7702 defining cash values. Also addressed were the implications of the current low interest rate environment on Section 7702, and a number of recent private letter (LTR) rulings, including LTR 20123009 on the treatment of a reduction of death benefit, LTRs 201302015 and 201302016 applying Section 72(s) to joint life guaranteed lifetime withdrawal benefits (GLWBs) covering non-spouses, and LTR 201304003 applying Section 1035 to a post-death exchange of a second-to-die contract. Finally, the session addressed partial exchanges under life insurance contracts, as well as recent court cases involving lapses of life insurance contracts when policy loans are present.

With respect to annuity contracts with an LTC rider, it was observed that the current IRS position reducing the cost basis of the contract for LTC benefits is problematic for withdrawals and other distributions that occur after LTC benefits have been received, as well as withdrawals that may occur while the insured is still too chronically ill to address medical costs or other lifetime needs.

The panel also discussed expected guidance on the definition of cash value under Section 7702, tracing the development from legislative history through the 1992 proposed Regulation 1.7702-2, and more recent guidance, ending the discussion with thoughts on what the new proposed regulations might do, and whether the IRS will persist with a broad definition of cash surrender value, or a more narrow definition, as some in the industry have argued.

050—TAXATION SECTION HOT BREAKFAST: CANADA-U.S. CROSS-BORDER ISSUES FOR POLICYHOLDERS

John T. Adney, JD, Davis & Harman LLP

Philip Friedlan, JD, MBA, Friedlan Law

At breakfast, John Adney and Phil Friedlan addressed issues related to the cross-border movement of Canadian and U.S. persons, discussing the implications for taxpayers with life insurance policies. They described the differences between the Canadian Exempt test and the U.S. definition of life insurance, as well as the proposed changes in the Canadian Exempt Test Policy (ETP) limitations, which would revise the standard to an eight-pay endowment at 90, based on 3.5 percent and the 1986-1995 CIA mortality table. Unlike the current test, the revised ETP would be applied to the cash value before any surrender charge. Friedlan also discussed the proposed changes in the rules involving the deduction of loan interest on leveraged policies. Finally, the panelists addressed the Canadian and U.S. tax implications of moving between the United States and Canada, noting that Canadian policyholders who become U.S. taxpayers are subject to Section 7702 definitions. As there is no treaty relief, Canadian policies are potentially subject to tax as "failed" life insurance contracts under Section 7702. Similarly, U.S. policyholders would become subject to the Canadian Exempt test.

058—TAX POLICY, RETIREMENT AND PRODUCT DESIGNS

Christian DesRochers, FSA, MAAA, EY

Joseph F. McKeever, III, JD, Davis & Harman LLP

Kimberly W. Lunn, JD, LLM, Allstate Life

Mark S. Smith, Esq., CPA, Pricewaterhouse LLP

The panel addressed the relationship between tax policy, annuity product design and policyholder actions relative to the purchase and liquidation of annuity contracts. Taxation as an annuity was explained, with the differences between qualified and non-qualified annuities summarized. While the Internal Revenue Code does not contain a formal definition of the term "annuity," a contract is treated as an annuity for federal income tax purposes if it is considered to be an annuity contract in accordance with the customary practice of life insurance companies, provides for guaranteed annuity payments and liquidates a fund over time.

Kim Lunn provided a historical perspective, noting the long-standing tax policy of the federal government to encourage savings through annuities, citing Abraham Lincoln's Annual Message to Congress in 1864. She also traced the taxation of annuities, citing the evolution of annuity products, as well as the way in which they are taxed, in response to changes in social and market changes over time.

Joe McKeever summarized two case studies of recent annuity developments shaped by tax policy considerations: non-qualified payout annuities, including immediate annuities, longevity insurance and the contingent deferred annuity; and qualified plan products, including the qualified longevity annuity contracts (QLACs) and guaranteed lifetime withdrawal benefits (GLWBs) in qualified plans.

Finally, Mark Smith discussed broad principles of tax policy, including the total tax burden, horizontal equity (treating similar taxpayers in a consistent way), ability to pay and progressivity/regressivity of a particular tax or tax system. Commenting that some provisions were intended to either encourage or discourage some behaviors, Smith cited, among other things, the deduction of contributions for qualified plans, the deferral of tax on income earned in a qualified plan, and required minimum distributions and the penalty tax on early withdrawals from qualified plans. Explaining the concept of "tax expenditure," Smith commented that any exercise in broadening the tax base necessarily begins with an examination of tax expenditures, including the exclusion from income of the cost of employer-provided health care, which is the largest single tax expenditure. The panelists discussed the inside buildup on life insurance, examining arguments for and against its classification as a tax expenditure. The panel concluded with a discussion of the development of recent guidance, noting both positive developments (contingent annuities) and challenges (annuity long-term care benefits).

INTERNAL REVENUE CODE SECTIONS: 7702 AND 7702A: INTRODUCTION TO THE TAX RULES AFFECTING LIFE INSURANCE PRODUCTS

Christian DesRochers, FSA, MAAA, EY
Brian G. King, FSA, MAAA, EY
John T. Adney, JD, Davis & Harman LLP
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This day-long teaching session focused on the basic qualification requirements of IRC Sections 7702 and 7702A, and provided an opportunity for attendees from a variety of backgrounds (legal, actuarial, compliance, IT, tax and so forth) to increase their knowledge in this area. The session presented included:

- Part I: Requirements for Qualification as Life Insurance under the Internal Revenue Code
- Parts II–IV: Computing the IRC Section 7702 and 7702A Limitations:
  - Methods and Assumptions
  - Future Benefits, Death Benefits and Qualified Additional Benefits
  - Material Changes and Exchanges
- Part V: Managing Product Tax Risk

The opening session began with a discussion of the tax treatment of life insurance, and the definitional tests, describing the role of contractual benefits and statutory assumptions used to compute limitations. Part II addressed methods and assumptions, noting that the methods by which actuarial values are to be computed are not specified, but are left to the issuer of the contract. Discussions in Part II covered restrictions on actuarial assumptions (mortality, interest and expense) that are key elements in developing the definitional limitations, and noting that the interaction of contract provisions and guarantees form the basis of the actuarial assumptions and the statutory restrictions that are imposed, with differences depending upon the issue date of the contract, all intended to restrict the ability of product designers to increase the definitional limits artificially through manipulation of the assumptions. Part III covered the computational rules that provide restrictions on the benefits assumed to be funded that are also key to the operation of the definitional limits. Part IV dealt with the adjustment rules under Section 7702 that allow for changes in benefits while maintaining definitional limitations, as well as the material change rules under Section 7702A. Finally, Part V described issues related to the management of product tax risk, focusing on the challenges that insurance companies face in administering products within the requirements of the Internal Revenue Code.