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The Life Insurance Product Tax Provisions of H.R. 1

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***An Introductory Note**. On April 26, 2018, the day that the following article was to be sent to Society of Actuaries editorial staff for final review and formatting for publication in* Taxing Times, *the Treasury Department and the IRS issued Notice 2018-41, 2018-20 I.R.B. 584, regarding the reporting requirements for life settlements, which is one of the two principal subjects discussed in the article. The Notice states that Treasury and the IRS intend to propose regulations regarding these requirements, describes in general terms the expected content of these regulations, and asks for comments on the proposed rules so described. See the sidebar for a summary of the proposals described in the Notice.*

The legislation enacted last December as H.R. 1, known just prior to its passage as the Tax Cuts and Jobs Act (the Act),[1] made several changes to the Internal Revenue Code affecting life insurance product (or policyholder) taxation. The first change, in the order of the Act's section numbering, altered section 7702,[2] the federal tax definition of "life insurance contract," to account for changes the Act made to the subchapter L rules governing the deductibility of life insurance reserves. The second change, implemented by three subsequent sections of the Act, was directed at life insurance contract sales, generally known as life settlement transactions. Enacting rules widely supported within both the life insurance industry and the life settlement industry, and endorsed (or acquiesced in) by the Treasury Department for a number of years,[3] these three sections, in order of appearance, added a complex reporting regime for life settlements, reversed a revenue ruling that had reduced the tax basis of a selling life insurance policyholder, and closed a perceived loophole in an exception to the section 101(a)(2) transfer-for-value rule.

This article will describe these provisions in detail and, where appropriate, comment on the significance of the changes made. It may be noted that these provisions were not in H.R. 1 as originally passed by the House of Representatives. Rather, they were added by an amendment to that bill as it was being considered by the Senate, and the amendment was accepted by the Conference Committee.[4]

SECTION 7702

As discussed elsewhere in this issue of *Taxing Times*, section 13517 of the Act rewrote the deductible life insurance reserve amount described in section 807(d). In doing so, it jettisoned much of the mechanism for calculating such amount that was brought into the Code by the Deficit Reduction Act of 1984. In its place, the Act brought in new rules that base the deduction (in part) on a percentage-based "haircut" of the reserve determined under the tax reserve method applicable to the contract. Among the items discarded from section 807(d) was the definition of the "prevailing commissioners' standard tables" in section 807(d)(5), which has no place in determining the deductible amount of life insurance reserves after 2017. Pursuant to that definition, the "prevailing commissioners' standard tables" associated with a life insurance (or other type of) contract generally were "the most recent commissioners' standard tables prescribed by the

IRS Notice 2018-41 states that proposed regulations to implement the information reporting requirements for life settlements under new Internal Revenue Code section 6050Y will:

- Clarify which parties are subject to the reporting requirements, including parties to a viatical settlement, and identify the extent to which the requirements apply to sales or acquisitions effected by transferors and transferees outside the U.S. and to sellers and issuers that are foreign persons for purposes of reporting by life insurers.
- Define "acquirer"—the purchaser of the life insurance policy interest—potentially to encompass any person, including a life settlement or viatical settlement provider or financing entity, that takes title or possession for state law purposes or acquires a beneficial interest in the life insurance contract, and potentially to refine what it means for the acquisition to be done "indirectly."
- Clarify that a reportable payment may include payments to persons other than the seller, such as brokers and, potentially, life settlement providers acting as intermediaries, and that the amount of the payment to be reported to the seller is the seller's net proceeds, *i.e.*, the gross proceeds minus any selling expenses (such as brokers' fees and commissions).
- Limit the reporting obligations imposed on life insurance companies to the company that is responsible for administering the contract being sold, so that the obligations would not apply to an indemnity reinsurer not responsible for contract administration.
- Require the contract issuer to report the amount that would have been received by the policyholder upon surrender of the contract, to determine the amount of the seller's gain that is ordinary income.
- Define "seller" for purposes of the life insurer's reporting obligations to include any person who transfers an interest in a life insurance contract to an acquirer in a reportable policy sale or to a foreign person.
- Limit the contract issuer's obligation to report the "investment in the contract" with respect to a seller other than the original policyholder to the information that is known to the issuer, and, similarly, limit the "estimate of the investment in the contract" that is required to be reported by the payor of a death benefit to include only the amount of premiums paid by the buyer under the contract, less the aggregate amount received by the buyer under the contract.
- With respect to the life insurer's reporting obligations, define "notice" of a transfer of a life insurance contract to a foreign person as any notice received by the contract issuer, including information provided for nontax purposes such as change of address notices or information relating to loans, premiums, or death benefits with respect to the contract, and in this connection, require every person (*e.g.*, life insurer) making payments of reportable death benefits to undertake the reporting obligations regardless of whether such person received a statement from the acquirer in the reportable policy sale.
- Require an acquirer to furnish the written statements required to be sent to the contract issuer by the later of 20 days after the reportable policy sale or five days after the end of any applicable state law rescission period, but in no event later than Jan. 15 of the year following the calendar year in which the reportable policy sale occurs. The deadlines for other required reporting will be the same as the deadlines for filing Form 1099-R, *i.e.*, Jan. 31 for written statements to sellers, Feb. 28 for paper information returns to the IRS, and March 31 for electronic information returns to the IRS.
- Not require reporting under new section 6050Y until final regulations are issued, and for reportable policy sales and payments of reportable death benefits occurring after Dec. 31, 2017 and before the issuance of final regulations, allow additional time after the date final regulations are published to file the returns and furnish the written statements required.

In addition, the Notice stated that amendments would be proposed to the section 101 regulations to reflect new section 101(a)(3) (the definition of reportable policy sale).

National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued."

While the Act eliminated the "prevailing commissioners' standard tables" term from section 807(d), it recognized that the term had played a prominent role in section 7702—and by cross-reference, in the "modified endowment contract" definition in section 7702A as well—since the amendment of section 7702 and the enactment of section 7702A by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).[5] Under these two statutes, and specifically by virtue of the "reasonable mortality" rule of section 7702(c)(3)(B)(i), the applicable computations of the net single premiums that limit the permissible cash values of life insurance contracts and the guideline premiums and 7-pay

premiums that constrain the premiums that may be paid for the contracts generally were required to use mortality assumptions not more conservative than those in the prevailing standard tables defined in section 807(d)(5).

To preclude a vacuum potentially created by the demise of the prevailing standard tables definition in section 807(d), section 13517(a)(4) of the Act (1) revised the section 7702(c)(3)(B)(i) reasonable mortality rule and (2) imported the definition into a new paragraph 10 of section 7702(f).

Revised reasonable mortality rule. As changed, the reasonable mortality rule now requires the premium computations to be based on:

> (i) reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in subsection (f)(10) [of section 7702]

Significantly, prior to this change, the reasonable mortality rule had read differently. Below is the wording of the former rule with deletions made by the Act shown by strike-outs and the Act's additions shown in italics:

> (i) reasonable mortality charges which meet the requirements ~~(if any)~~ prescribed in regulations *to be promulgated by the Secretary* ~~and which (except as provided in regulations)~~ *or that* do not exceed the mortality charges specified in the prevailing commissioners' standard tables ~~(~~as defined in ~~section 807(d)(5)) as of the time the contract is issued~~ *subsection (f)(10)*.

As originally enacted, section 7702(c)(3)(B)(i) expressly gave the Treasury Department regulatory authority (a) to prescribe requirements that mortality charges would need to meet, in addition to not exceeding the charges specified in the prevailing standard tables, in order to be considered reasonable mortality charges, and (b) to expand the scope of reasonable mortality charges to encompass charges exceeding those of the prevailing standard tables. With the wording additions noted above, and more specifically the replacement of "and which" with "or that," the revised rule removes the prior express authority of the Treasury Department to limit the mortality assumptions used in the premium computations to amounts less than those in the prevailing standard tables. That authority, contemplated for use in regulations proposed in July of 1991, ultimately was never exercised, particularly in light of objections that any such requirement would have made the section 7702 compliance of whole life insurance difficult if not impossible. The elimination of that authority quells a concern that more or less haunted the life insurance industry for nearly three decades.

The revised rule leaves in place the Treasury's express authority to define the circumstances in which mortality assumptions that exceed those in the prevailing standard tables are "reasonable" and thus may be used in the section 7702 and 7702A premium computations. These circumstances would occur, for example, under contracts insuring lives that are rated as substandard risks, and they could also arise under contracts issued in guaranteed-issue or simplified-issue cases. Substandard-risk and guaranteed-issue (common for group) contracts typically experience worse mortality than those that are fully underwritten, and efforts to streamline the underwriting and issuance of contracts in the individual market through the use of simplified underwriting techniques could result in some deterioration of mortality experience. In such cases, where mortality experience for these types of contracts exceeds the mortality in the prevailing tables, there is justification for Treasury guidance permitting the use of higher mortality assumptions in establishing compliance with sections 7702 and 7702A. Such guidance also would be appropriate in view of the historic role of the interim rule for mortality charges of TAMRA section 5011(c)(2), which remains in effect in the absence of regulations. The exercise of the Treasury's authority also could be called upon, as has been the case in the past, to align the requirements of the reasonable mortality rule with the advent of new tables in circumstances where the three-year transition rule of new section 7702(f)(10) (discussed below) is inadequate to do so.

> Changes to section 7702(c)(3)(B)(i) and 7702(f)(10) … "apply to taxable years beginning after December 31, 2017."

New section 7702(f)(10). While the wording of the reasonable mortality rule itself no longer references the use of the prevailing standard tables in effect "as of the time the contract is issued," the latter wording still applies to determine the tables to be used in the section 7702 and 7702A premium computations. This is brought about by the wording imported into new section 7702(f)(10) from former section 807(d)(5)(A), which recites that the prevailing standard tables are "the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued." Section 7702(f)(10) then goes on to incorporate into the new section

7702-based definition of prevailing standard tables the three-year transition rule that previously appeared in section 807(d)(5)(B). The latter rule had enabled the former reserve deduction limit to be computed using a pre-existing mortality table for three years after a new table had met the requirements to be considered "prevailing." To preserve this rule for the section 7702 and 7702A premium computations, the second sentence of new section 7702(f)(10) reads:

> If the prevailing commissioners' standard tables as of the beginning of any calendar year (hereinafter in this paragraph referred to as the "year of change") are different from the prevailing commissioners' standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.

While section 13517(a)(4) of the Act thus rescued and brought over to section 7702 the basic definition needed to allow a portion of the reasonable mortality rule to operate, it apparently chose not to resuscitate the "lowest reserves" rule of former section 807(d)(5)(E). That provision, one of the odder mandates of the Code, required insurers to take an extra step in computing the limit on deductible reserves where more than one mortality table (or options under a table) met the prevailing standard tables definition. In such a case, insurers were instructed by section 807(d)(5)(E) to use the table (and option) that "generally yields the lowest reserves. . . ." The additional requirement set forth in section 807(d)(5)(E), coupled with the prior instruction in section 7702 to use the prevailing standard tables in the premium computations, caused some speculation about whether the version of the prevailing standard tables that yielded the lowest reserves needed to be used for satisfying the reasonable mortality requirements of section 7702(c)(3)(B)(i). The Code is not a frequent user of terms like "generally," leaving one to suspect that the section 807(d)(5)(E) rule had more to do with revenue-raising than with principle. It also simply could have reflected congressional uncertainty, and perhaps lack of comfort, regarding future mortality tables that might arise. The Act may wisely have chosen to consign this rule to the realm of archaeology.

In choosing to retain the concept of "prevailing commissioners' standard tables" in the operation of the reasonable mortality rule, the Act seemingly took notice of the continuing use of such tables in the net premium reserve component of the annual statement "reported reserve" computed in accordance with chapter 20 of the new NAIC Valuation Manual, *i.e.*, VM-20. Under VM-20, life insurance companies are generally required to calculate a net premium reserve for all life insurance contracts as part of the process for determining the reported reserve. Therefore, as long as the net premium reserve remains as a component of the calculation of the reported reserve for a life insurance contract under VM-20, and as long as the prevailing standard tables as defined in new section 7702(f)(10) are used in computing that component, the reasonable mortality rule should continue to function as it has over the past three decades.

Effective date. The changes to section 7702(c)(3)(B)(i) and 7702(f)(10) just described "apply to taxable years beginning after December 31, 2017."[6] Hence, these changes are now in effect. There could be questions about how this rule interacts with the original effective date of TAMRA's reasonable mortality rule. Interestingly, the changes made to section 7702 modify the tax law governing the definition of "life insurance contract" and "modified endowment contract" without one iota of guidance or even comment in the congressional committee reports, *i.e.*, the Act's legislative history. Much of what is known about sections 7702 and 7702A derives from the legislative history of past enactments, and so it is curious that the congressional tax-writing committees chose to be silent on this subject, even though the legislative history of the Act commented at length on the tax reserve changes wrought by section 13517[7] and did likewise for the life settlement-related changes next discussed.

LIFE SETTLEMENTS

From its inception, the federal income tax law has provided an exclusion from gross income for amounts paid under a life insurance contract by reason of the death of the insured.[8] Almost as long, this exclusion has been limited by a provision known as the transfer-for-value rule. Under this rule, found in section 101(a)(2), if a life insurance contract is sold (or otherwise transferred for valuable consideration) by its owner, the excludable amount of the death benefit generally is limited to the sale price plus premiums and other amounts subsequently paid by the purchaser, thereby subjecting to tax the amount of the death benefit in excess of the transferee's basis in the contract.[9] On the other hand, the statute contains several exceptions to this rule, under one of which the death benefit remains income tax-free where the transferee's tax basis in the contract is determined in whole or in part by reference to the transferor's basis.[10] Thus, where a contract is transferred by gift and the donor's basis carries over to the donee, this exception usually allows the gift to avoid the transfer-for-value rule, even in a part-gift and part-sale transfer.

In many instances, the federal income tax rules rely on widespread tax reporting regimes to enable their enforcement by requiring those who make potentially taxable payments to report those payments to both the payee and the IRS. To

achieve this result for life settlements, life insurance companies need to be aware of the characteristics of the underlying change in ownership, *i.e.*, to know whether the transaction involves a sale or, more specifically, whether one of the exceptions to the transfer-for-value rules in section 101(a)(2) applies. While life insurance companies generally have not been enthused about having contracts they've issued sold to third parties and have not been averse to reporting death benefits in such cases as taxable pursuant to the transfer-for-value rule, they often lack information necessary to such reporting. At best, there has been limited reporting by life insurance companies when the death benefits of those contracts are paid to the third-party purchasers (or their assignees). Further, companies should not report a death benefit as taxable when one of the exceptions to the transfer-for-value rules applies (as where a contract is transferred by gift), and reporting a specific taxable amount when the section 101(a)(2) exceptions do not apply requires knowledge of tax basis that professional purchasers of contracts usually do not share with insurance companies.

In an effort to preclude avoidance of section 101(a)(2)'s transfer-for-value rule, section 13520 of the Act imposes tax reporting requirements where an existing life insurance contract is purchased in what new section 6050Y denominates a "reportable policy sale," and also imposes reporting requirements on the payor (*i.e.*, the life insurance company) where "reportable death benefits" are paid. In addition, as part and parcel of this effort (as discussed further below), section 13521 of the Act sets forth rules for determining the basis of a life insurance (or annuity) contract, and section 13522 of the Act narrows the exceptions in the transfer-for-value rules so that they do not apply where an interest in a life insurance contract is transferred in a reportable policy sale. Each of these sections of the Act is explored further in the discussion that follows.

Reporting requirements—acquisition of a life insurance contract—the buyer's turn. To facilitate the information flow among purchasers, life insurance companies and the IRS for life settlement transactions, the Act imposes a new reporting regime at the time of a reportable policy sale. The reporting requirement under new section 6050Y applies to "every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year."[11] Hence, the new reporting requirement captures within its net every life

settlement company (or individual) that obtains, in a transfer for value, any interest in a life insurance contract where "the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract)," which is the definition of a reportable policy sale that appears in new section 101(a)(3)(B) as added by the Act.[12] The reportable acquisition, moreover, may be direct or indirect; the latter is described in the statute as including the acquisition of an interest in a partnership, trust or other entity that holds an interest in the life insurance contract.[13] And this reporting requirement does not cease with the initial sale of the contract, since it is not uncommon for contracts sold in life settlements to have subsequent purchasers (as reflected in Revenue Ruling 2009-14).[14] Subsequent acquirers of interests in contracts also are subject to the required reporting.

Pursuant to the new reporting requirement, the buyer is to file an information return with the IRS reporting certain information about the life insurance contract purchase, and also is to provide an information statement to the seller of the contract and to the life insurance company that issued it containing (almost) the same information. On the information return filed with the IRS[15] and the information statement to the seller,[16] the buyer reports:

- The buyer's name, address and taxpayer identification number (TIN).
- The name, address and TIN of each recipient of a "payment" in the reportable policy sale, with this payment being defined as the amount of cash and the fair market value of any consideration transferred in the sale.[17]
- The date of the sale.
- The name of the "issuer" and policy number of the contract acquired.
- The amount of each payment.

Where a contract is owned by multiple parties, so that each of them is a "seller," the information statement presumably must be provided to each of them. The same details are to be provided in the information statement to the contract's issuer, with the exception that the amount(s) of the purchase payment(s) need not be reported to the issuer.[18]

In this connection, it is noteworthy that section 6050Y uses, in a number of places, the term "issuer" rather than "insurance company." The reason for this terminology is that the statute employs a special definition for this purpose: The issuer is "any life insurance company that bears the risk with respect to a life insurance contract on the date any return or statement is required to be made under this section."[19] Hence, while the issuer in a specific case may be the insurer that originally issued the contract, it is possible, such as where an intervening assumption reinsurance transaction changes the obligor on the contract to a new carrier, that the assuming insurer is the party that is to receive the information statement just described or to file the returns and information statements discussed below.

At this point, one may stop to ask a few questions. First, why does the statute exclude the purchase payment's amount from the information required to be shared with the life insurer? Without this information, the insurer lacks the necessary information for determining the taxable amount of the death benefit, limiting its ability to tax report income and withhold on the proceeds. The answer is that the legislation embodies a compromise, a well-orchestrated dance of sorts, between the life insurance industry and the life settlement industry. The professional buyers of contracts, while willing to disclose the amounts of the purchase payments to the IRS (which by law generally may not disclose the information), were not willing to disclose them to the insurers. This arrangement, together with the insurer's information-reporting requirements described next, should provide the IRS with the data needed to enforce compliance with the transfer-for-value rule, assuming the agency's information collection system is up to the task of matching the information provided by the buyer and the insurer, and further assuming that the buyer in question actually must file the return. The latter assumption prompts the next question: What if the buyer is an offshore entity, existing beyond the taxing jurisdiction of the United States? Many purchasers of interests in previously issued life insurance contracts are foreign parties. As discussed below, this may require withholding on the taxable portion of death benefits paid. However, if the insurance company does not know the amount of the purchase price, withholding may need to be based upon the full death benefit. Both new section 6050Y and its legislative history[20] take notice of the possibility of foreign contract owners, turning to the contract issuer for help in ensuring the sufficiency of information reporting as described below. The IRS may also rely on FATCA-required reporting to produce the needed data in such a circumstance (more on this later). And perhaps a further question is in order: Might contract acquisitions in transfers-not-for-value, such as gifts, also be caught within the new reporting net? Looking solely at the definition of a reportable policy sale in new section 101(a)(3), the answer arguably is yes, but the reporting requirements themselves as spelled out in section 6050Y(a) suggest otherwise. Those requirements, as noted above, include disclosure of the amount of a payment for a contract and the "date of the sale," thereby positioning the reporting requirements squarely within the transfer-for-value context. The IRS presumably will agree with this view when it publishes guidance on these

requirements, as the agency's updated Priority Guidance Plan said would be done,[21] as well as when the agency frames the new reporting forms.

Reporting requirements—seller's basis in the life insurance contract—the insurer's turn. On receipt of the buyer's information statement, or on receipt of any "notice" that the contract is being transferred to a "foreign person," the issuer is required to file an information return with the IRS[22] and to send an information statement to the seller of the contract,[23] containing:

- The name, address, and TIN of the seller (including, according to the legislative history, that of the transferor to a foreign person).
- The investment in the contract within the meaning of section 72(e)(6) at the time of sale (*i.e.*, usually the sum of the premiums paid for the contract less any untaxed distributions from it).
- "The policy number" of the contract.[24]

The legislative history proceeds to elaborate on these requirements of the new statute, apparently to prompt action from Treasury and the IRS.[25] First, it clarifies that the initial element above (identification of the seller) includes the transferor of the contract to a foreign person. Second, regarding such a transfer, the history observes that the "notice" of the transfer of a contract to a foreign person "is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract." And, perhaps foreshadowing the clarification that the legislation makes in section 13521 of the Act (described below), the same history refers to the second item above—the section 72(e)(6) investment in the contract—as the "basis of the contract." That phrasing is music to the ears of life insurers and life settlement purchasers alike, as will be discussed subsequently. The requirement of reporting the investment in the contract to the seller (and the IRS) presumably is to enable the seller's filing of a proper tax return (*e.g.*, IRS Form 1040) and to enhance the tax collector's ability to verify its propriety.

Effective date for the contract sale reporting requirements. The reporting requirements for "reportable policy sales" just described are effective for both contract buyers and contract issuers with respect to sales occurring after Dec. 31, 2017,[26] and are subject to the same penalties for failure to comply with the requirements as are other mandated information returns and statements.[27]

Reporting requirements—reportable death benefits. When a "reportable death benefit" is paid under a life insurance contract, section 6050Y requires the payor insurance company—described in the statute as "a person who makes a payment of reportable death benefits"—to file an information return with the IRS about the payment and to provide an information statement to the payee as well. Not surprisingly, such a reportable death benefit is defined in the statute as "an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale." Pursuant to this requirement, the payor's information return[28] (to the IRS) and information statement[29] (to the purchaser) reports:

- The name, address and TIN of the person making the death benefit payment(s) (presumably the insurer).
- The name, address and TIN of each recipient of such payment.
- The date of each such payment.[30]
- The gross amount of such payment.
- The payor's estimate of the buyer's section 72(e)(6) investment in the contract.

The last item on this list also is worthy of comment. The statute's use of the term "estimate" suggests that the payor/insurer may not know, or perhaps that it is not expected to know, the precise amount of the buyer's investment in the contract within the meaning of section 72(e)(6). This presumably follows from the omission of any required reporting to the insurer of the purchase price the buyer paid to the seller, an amount that

should constitute the buyer's section 72(e)(6) investment in the contract at the point of sale. That an amount equal to the buyer's purchase payment is its initial investment in the contract is mandated by section 72(g), which equates that amount with the "aggregate amount of the premiums or other consideration paid" component of the investment in the contract. Of course, it is possible that the buyer would voluntarily disclose the purchase payment amount to the insurer. Alternatively, the insurer could simply report what it knows to be the case, *i.e.*, the buyer's investment in the contract (the premiums it pays to the insurer less the untaxed distributions it receives) after the sale. It would seem appropriate for the section 6050Y guidance promised by the Priority Guidance Plan to address the nature of the estimate the insurer is to report.

In any event, while the amount so reported as investment in the contract may be pertinent to determining the taxable amount of gain in the contract under section 72(e)—should the buyer decide to surrender the contract or take withdrawals from it—the section 72(e)(6) investment in the contract technically has little to do with determining the taxable amount of the death benefit under section 101(a)(2), in that the latter provision does not reference section 72(e)(6). One would think that determining the taxable portion of the death benefit is the whole point of this branch of the reporting exercise. Pursuant to section 101(a)(2) itself, the excludable amount of the death benefit is defined similarly to the section 72(g) "aggregate amount of the premiums or other consideration paid," without making any reference to section 72(g) let alone to section 72(e)(6). Given the change made by section 13521 of the Act, perhaps Congress was equating the section 72(e)(6) investment in the contract with tax basis and, in turn, with the section 101(a)(2) excludable amount. If so, it may be that the insurer's estimate of the buyer's investment serves all of these purposes. Again, the promised IRS guidance may shed some light on this.

Where a life insurance policyholder sells his or her contract to a foreign purchaser, the withholding tax rules of sections 1441-1442 and 1471 (*i.e.*, FATCA) may come into play when amounts are distributed from the contract. A death benefit paid by a U.S.-based insurance company under a life insurance contract originally issued in the United States may well give rise to U.S. source fixed, determinable, annual or periodical (FDAP) income, which is subject to the 30 percent withholding tax imposed under both of those sections. The FATCA-required withholding can be avoided, of course, with the appropriate registration of, or reporting by, an entity that is the purchasing foreign party, as well as the proper documentation provided by the recipient to the payor. Where section 1441 or 1442 is concerned, in some places a treaty may be invoked to avoid or reduce the withholding tax (based on a valid claim of benefits on a Form W-8BEN or W-8BEN-E). But the insurer must make a judgment about whether to withhold tax and, if so, how much to withhold. Under the applicable regulations, where the tax basis of a payment of U.S. source FDAP income to a foreign person is unknown, rendering the amount of the taxable income unknown, withholding is based on the gross amount of the payment.[31] This would seem to be incentive enough for a foreign life settlement company to disclose the amount of the purchase payment to the insurer, absent a claim of treaty-based exemption.

These reporting requirements apply to death benefits paid after Dec. 31, 2017,[32] and like the requirements applicable to reportable policy sales, are subject to penalties for failure to comply with the requirements.[33]

Clarification of a seller's basis in a life insurance contract. Prior to a decade ago, a policyholder's tax basis in his or her life insurance contract at the time it is sold in a life settlement transaction was widely understood to be the investment in the contract as defined in section 72(e)(6) (again, the sum of the premiums paid for the contract less any untaxed distributions from it). That changed with the publication of Revenue Ruling 2009-13,[34] in which the IRS ruled (in "situation 2") that where a cash value life insurance contract is sold by the original owner, the seller's basis is reduced by prior cost of insurance, a view that contrasted starkly with both the previous understanding and with the treatment of a contract surrender under section 72(e) (also discussed in the ruling). The reasoning underlying the ruling appeared to be that the reduction for cost of insurance charges was necessary to account for the insurance protection the policyholder received before the sale. The ruling cited *Century Wood Preserving Co. v. Commissioner*[35] and characterized the court as concluding that a taxpayer who sold a life insurance contract could not include in basis amounts that were used to provide annual insurance protection.[36] Situation 2 of this ruling was controversial, to say the least, and perhaps adding to the controversy, in a companion ruling, Revenue Ruling 2009-14,[37] the IRS held that such a reduction in basis did not apply to the buyer of the contract upon its subsequent sale of the contract. The distinction between the original sale case and subsequent sale case, as explained in the latter ruling, was that the purchaser from the original owner did not purchase the contract for protection against economic loss upon the insured's death but rather acquired and held the contract solely with a view to making a profit.

There were many problems with the IRS's position in situation 2 of Revenue Ruling 2009-13, as detailed in a prior *Taxing Times* article.[38] For example, in the case of personal property unrelated to business or investment, federal tax law generally makes no provision for adjusting the basis of the property to account for personal use or consumption. In determining gain on the sale of

such property, the property's basis equals its cost, unadjusted for personal use or consumption. The IRS position, it was pointed out, ran completely counter to this treatment. The authorities the ruling cited in support of its position, moreover, dealt with the treatment of basis in cases of losses incurred when businesses sold or surrendered life insurance contracts they had purchased, a situation distinguishable at a variety of levels. The IRS position, many said, lacked a sound basis.

Into this fray stepped section 13521 of the Act, with rousing support from both the life insurance industry and the life settlement industry, and with Treasury Department acquiescence if not endorsement. That provision rewrites section 1016(a)(1), governing adjustments to tax basis, to provide in new subparagraph (B) that "no adjustment [to basis] shall be made . . . for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract." The legislative history briefly elaborates on the meaning of this revision of the statute, saying the mortality, expense and other reasonable charges just referred to are "known as 'cost of insurance'" and observing that the addition of the new rule "reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance."[39]

New section 101(a)(3) applies to transfers occurring after Dec. 31, 2017.

This amendment of the tax basis rules for life insurance (and annuity) contract sales is effective for transactions entered into after Aug. 25, 2009.[40] Thus, the amendment dates back to the effective date of Revenue Ruling 2009-13, supporting the view that the revisions to section 1016 merely clarify the law rather than alter it (a view also supported by the legislative history).[41] One might also observe that the revised section 1016(a)(1)(B) rule clarifies the policyholder's basis in the case of taxable exchanges as well, a point not covered in the IRS's ruling. The legislation does not appear, or purport, to change what the IRS said in Revenue Ruling 2009-14.

Narrowing the transfer-for-value exceptions. As previously noted, exceptions exist to the section 101(a)(2) transfer-for-value rule. Prior to the Act, an exception applied where the transferee's basis in the contract was determined in whole or in part by reference to the transferor's basis in the contract.[42] Hence, the death benefit remained income-tax-free in cases where the original policyholder's basis "carried over" in the transfer, such as a transfer by gift (generally including a part-gift and part-sale transaction) or in connection with a corporate reorganization. Exceptions also applied in the case of a transfer of a contract to the individual insured under the contract, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[43]

These exceptions to the transfer-for-value rule, dating back to the 1940s, have generally stood the test of time, but of late, with the advent of life settlements and some practices of the promoters thereof, an abuse of the exceptions was perceived to arise. By way of example, some life settlement transactions were structured as partnerships between a buyer and a seller who was also the insured under the contract, ostensibly enabling the buyer to benefit from the exception for a transfer to a partnership in which the insured is a partner and thereby retain the income-tax-free status of the death benefit, despite the obvious transfer of the contract for value. The seller/insured/partner may be accorded a very minor interest in the partnership and thereafter may exit the partnership.

To preclude any such abuse, section 13522(a) of the Act, while leaving intact the historic exceptions in section 101(a)(2), added a new section 101(a)(3) to limit the exceptions' scope. According to the new provision, the exceptions to the transfer-for-value rule do not apply where the transfer of a life insurance contract, or any interest therein, constitutes a "reportable policy sale." This reportable policy sale, as defined in new section 101(a)(3)(B), is the same one that triggers the reporting requirements discussed earlier. Thus, some portion of the death benefit ultimately payable under such a contract—the excess of the death benefit over the buyer's purchase price plus any premiums subsequently paid (adjusted for any untaxed distributions from the contract)—will be includable in the buyer's gross income for tax purposes. New section 101(a)(3) applies to transfers occurring after Dec. 31, 2017.[44]

While legislation enacted to preclude tax abuse is laudable, anyone conversant with the history of federal income tax law knows that anti-abuse legislation often throws off flack that hits innocent parties. This legislation may well have done so, in that the sweep of the new section 101(a)(3) rule could be construed, for example, to include some contract transfers in connection with corporate reorganizations. Yet it was to enable contract transfers in such cases, among others, that the section 101(a)(2) exceptions were written as they are. The authors understand that further work is being done to refine the anti-abuse rule so that it can operate without detracting from the tax treatment of legitimate life insurance contract transfers. This could also be a fit subject for the promised administrative guidance.

CONCLUSION

On balance, the changes the Act made to the Internal Revenue Code in the realm of life insurance product (or policyholder) taxation appear to be beneficial. Section 7702 was altered to

preserve the role played by the prevailing commissioners' standard tables in determining "reasonable" mortality charges while deleting the express authorization of regulations that might require the use of lesser charges in the section 7702 and 7702A computations. Life settlement transactions, in the past somewhat shrouded in darkness, were brought into the light by means of a web of reporting requirements, and the basis of selling policyholders was clarified to align with the tax treatment of non-business property sales generally. And the transfer-for-value rules were modified in an effort to preclude abuse. As with all tax legislation, these changes prompt questions and concerns, most if not all of which may be susceptible to resolution through IRS guidance. ■

The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or any member firm of the global EY organization or of Davis & Harman LLP.

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ENDNOTES

1 P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

2 Unless otherwise noted, references to "section" are to provisions of the Internal Revenue Code of 1986, as amended through the date of this writing (the "Code").

3 This portion of the legislation passed the Senate in 2012 as part of a highway funding bill but was ultimately deleted from the measure before its final passage. *See* John T. Adney, Bryan W. Keene and Joshua R. Landsman, "Life Settlements: Congress Wades Into the Fray," *Taxing Times*, October 2012, Vol. 8, Issue 3 (Society of Actuaries 2012).

4 H.R. Rep. No. 115-466 (2017) (Conference Report) at 478, 486.

5 P.L. 100-647, 102 Stat. 3342 (Nov. 11, 1988).

6 Section 13517(c)(1) of the Act.

7 Conference Report at 476.

8 Section 101(a)(1).

9 According to the flush language of section 101(a)(2), "other amounts" includes interest with respect to the contract that was not deductible under section 264(a)(4).

10 Section 101(a)(2)(A).

11 Section 6050Y(a)(1), as added by section 13520(a) of the Act.

12 Section 6050Y(d)(2). *See* section 13522(a) of the Act, adding new section 101(a)(3).

13 Section 101(a)(3)(B).

14 2009-21 I.R.B. 1031.

15 Section 6050Y(a)(1).

16 Section 6050Y(a)(2).

17 Section 6050Y(d)(1).

18 Section 6050Y(a)(2)(B). On the information statements, the buyer must also supply the name, address and phone number of the buyer's "information contact." Section 6050Y(a)(2)(A).

19 Section 6050Y(d)(3).

20 Conference Report at 485.

21 2017-2018 Priority Guidance Plan (Feb. 7, 2018) (referring to "Guidance under §§101 and 1016 and new §6050Y regarding reportable policy sales of life insurance contracts"). *See* the note at the outset of this article regarding IRS Notice 2018-41 and the related sidebar.

22 Section 6050Y(b)(1).

23 Section 6050Y(b)(2).

24 On the information statements, as was the case with the buyer, the insurer must also supply the name, address and phone number of the insurer's "information contact." Section 6050Y(b)(2)(A).

25 *See supra* note 20.

26 Section 13520(d)(1) of the Act.

27 Section 6724(d)(1)(B)(xxvi) and (2)(JJ) as added by section 13520(c) of the Act.

28 Section 6050Y(c)(1).

29 Section 6050Y(c)(2).

30 The use of the term "such" in connection with "payment" in this list is necessary here and was borrowed from the statute itself, since the reporting described in this list refers to the death benefit payment or payments, not to the term "payment" described in the statute's definitional section. The latter "payment" (*see* Section 6050Y(d)(1)) is the one for the purchase of the contract, limited by definition to the consideration for the reportable policy sale.

31 *See* Treas. Reg. sections 1.1441-3(d)(1) and 1.1471-2(a)(5).

32 Section 13520(d)(2) of the Act.

33 *See supra* note 27.

34 2009-21 I.R.B. 1029.

35 69 F.2d 967 (3rd Cir. 1934).

36 The ruling also cited *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2dCir. 1935) and *Keystone Consolidated Publishing Co. v. Commissioner*, 26 B.T.A. 1210 (1932), as authority for its holding.

37 *See supra* note 14.

38 *See supra* note 3.

39 Conference Report at 486.

40 Section 13521(b) of the Act.

41 Conference Report at 483 (referring to "clarification of the tax basis of life insurance contracts").

42 Section 101(a)(2)(A).

43 Section 101(a)(2)(B).

44 Section 13522(c) of the Act.