Session 46: Product Taxation Update

SOA Antitrust Disclaimer
SOA Presentation Disclaimer

2019 LIFE & ANNUITY SYMPOSIUM

Product Taxation Update

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Federal Legislative Proposals Affecting Life Insurance Products

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SECURE Act and RESA

- Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 (H.R. 1994, 116th Congress)
  - Annuity-specific provisions
    - Fiduciary safe harbor for selecting annuity providers
    - Portability of lifetime income investments
    - Lifetime income disclosures
  - RMD provisions
    - Limit "stretch" of post-death RMD
    - Increase required beginning date to age 72
    - Allow post-70½ IRA contributions
    - Increase IRA contribution limit
- Retirement Enhancement and Savings Act (RESA) of 2019 (S. 972, 116th Congress)

The Retirement Plan Simplification & Enhancement Act (H.R. 4524, 115th Congress)

- Relief from the Minimum Income Threshold Test ("MITT") in RMD regulations
  - The MITT limits "increasing" annuity payments (Treas. Reg. § 1.401(a)(9)-6, Q&A-14)
  - Legislation would exempt:
    - Annuity payments that increase by less than 5% annually
    - Certain commutations and accelerations of payment
    - Dividends under participating annuities
    - Return of premium death benefit
  - Address outdated mortality tables by allowing reasonable tables or other actuarial assumptions actually used in pricing
  - MITT would be deemed satisfied if initial annuity payment is at least equal to initial RMD payment under individual RMD rules
- Qualifying Longevity Annuity Contracts ("QLACs") in Treas. Reg. § 1.401(a)(9)-6, Q&A-17
  - Increase contribution limit to $200,000
  - Clarify spousal rules in the event of divorce
  - Repeal 25% premium limit
- Other provisions

Retirement Security and Savings Act (S. 3781, 115th Congress) – the *Portman-Cardin Bill*

- Annuity RMD distributions can partially count toward account RMDs
- Facilitate plan distribution options (e.g., annuity contract investments, GLWBs, and managed payout funds)
- Update RMD life expectancy tables (See also Executive Order 13847)
- Expand EPCRS
- Allow 403(b)(7) custodial accounts to invest in collective investment trusts.
- Other helpful provisions

Regulatory Developments

Regulatory Developments

- Policy statement by Treasury Department and IRS on change to longstanding practices regarding certain forms of regulatory and sub-regulatory guidance
  - Curb use and effectiveness of temporary regulations
  - Refrain from issuing sub-regulatory guidance, such as notices
  - 18-month limit on period for which notices announcing the intent to issue future regulations will be effective against taxpayers
- Revoking Notice 2015-49 on intent to amend RMD regulations to prohibit certain lump-sum cash outs from DB plans
- ERISA Advisory Council report on lifetime income solutions as a QDIA
- Proposed regulations on reportable policy sales

Proposed Regulations on Reportable Policy Sales

"Reportable Policy Sale" (IRC § 101(a)(3)(B))

- *Defined:* The acquisition of an interest in a life insurance contract, directly or indirectly (such as through a partnership or trust), if the acquirer has no other substantial family, business, or financial relationship with the insured
- An indirect acquisition of an interest occurs when a person becomes a beneficial owner of a partnership, trust, or other entity that holds an interest in the life contract
- Includes the creation of an enforceable right to proceeds
- Generally does not include
  - The designation of an irrevocable beneficiary
  - Ordinary course of business transactions
- Addressed concerns about corporate mergers and reorganizations
  - Exception for C corporation if no more than 50% of assets consist of life insurance
  - Exception for acquisition of shares in a C corporation that holds an interest in a life contract, unless the C corporation primarily owns life contracts
  - Exceptions for transfers between related entities and members of affiliated groups

Modifications to the Transfer for Value Rules

- The death benefit under a life insurance contract generally is excluded from gross income under IRC § 101(a)
- However, if a life contract is transferred for value, the amount excluded is limited generally to the consideration and premiums paid, subject to certain exceptions for certain transfers to:
  - the insured,
  - a partner of the insured,
  - a partnership in which the insured is a partner, or
  - a corporation in which the insured is a shareholder or officer
- These exceptions do not apply to reportable policy sales

Reporting Requirements

- **Reporting the Sale: IRC § 6050Y(a)** – Every person who acquires, directly or indirectly, a life insurance contract (or any interest in such a contract) in a "reportable policy sale" must report certain information to the IRS (draft Form 1099-LS), seller, and "issuer"
- **Reporting Seller's Basis: IRC § 6050Y(b)** – Upon receipt of 1099-LS, or upon "notice of a transfer to a foreign person," the "issuer" must report certain information to the IRS and seller (draft Form 1099-SB)
- **Reporting the Death Benefit** – Upon payment of a reportable death benefit, the "issuer" must report to IRS and the recipient (Form 1099-R or 1042-S)
- **Timing requirements** – Delayed until after final regulations are published

Who is the "Issuer"?

- Depends on the context
- In general, the issuer means:
  - any person that bears any part of the risk with respect to the contract, and
  - persons responsible for administering the contract
- Both indemnity reinsurer and the original issuer are "issuers"
- Can include a designee of an issuer
- Acquirer only needs to report to the issuer responsible for administering the contract on the date of the reportable policy sale
- For transfers to foreign persons, an issuer is any person that:
  - receives notice of the transfer,
  - was an issuer on the date of transfer or receipt of notice, and
  - is responsible for administering the contract

Adjusted Basis

- IRC § 1016(a)(1) is amended to clarify that no adjustments are made to a taxpayer’s basis “for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contact”
- Reverses portion of Rev. Rul. 2009-13 which held that basis is reduced by COI for certain policy sales
- Retroactive application to August 25, 2009

Missing Participants and Escheatment

State Law Overview

- Insurers must report abandoned property to the state
  - Personal property is deemed abandoned if no contact w/owner during “dormancy” period
  - Dormancy period normally begins when amount is payable
    - E.g., for an IRA, when a distribution was “attempted” or when a tax penalty would arise absent a distribution (RMDs)
  - Dormancy period normally lasts 3 years
- Insurers then must pay the contract value to the state
  - Certain notice requirements for insurer and state
  - State assumes custody of the proceeds
- States have stepped up collection efforts
  - States prefer gross proceeds
  - Insurers might have withholding obligation to IRS

Common Scenarios for Insurers

- Death
  - Plan participant, IRA owner, or non-qualified annuity owner dies
  - Insurer sends a check to the beneficiary of record
  - Check is returned or never cashed
- Lifetime payments
  - Non-qualified deferred annuity reaches its maturity date
  - Required minimum distributions commence pursuant to tax law
  - Insurer sends check to the owner
  - Check is returned or never cashed
- No taxpayer ID number or address for a beneficiary

Internal Revenue Code

- IRC § 3405 – Tax withholding for designated distributions
  - Generally any distribution or payment from or under a qualified plan, IRA, or commercial annuity (including life insurance)
  - Exception if the “individual” elects out, but cannot elect out in the case of any “eligible rollover distribution” from a qualified plan
  - Exception if “reasonable to believe … not includible in gross income,” but this exception is unavailable for traditional IRAs
- IRC § 6047(d) – Tax reporting for designated distributions
  - Applies to any plan or contract from which designated distributions may be made
- IRC § 408(i) – General reporting requirement for IRAs

Need for Guidance

- GAO report on unclaimed 401(k) accounts
- Possible legislation
- Regulatory guidance
    - IRS, DOL & PBGC are coordinating
    - Concerns raised with IRS
    - Memoranda for Employee Plans (EP) Examinations Employees
    - Guidance item on Priority Guidance Plan

Rev. Rul. 2018-17 on Traditional IRAs

- Facts
  - Individual is a U.S. person and has an "interest" in a traditional IRA
  - Individual made no withholding election under IRC § 3405(b)(2)
  - Issuer must pay Individual's interest to state unclaimed property fund
- Conclusion #1: Withholding required under IRC § 3405
  - The exception for "reasonable to believe is not includible in gross income" does not apply to traditional IRAs (flush language)
  - Thus, the payment is a designated distribution
  - No election out, so 10% withholding applies (nonperiodic distribution)
- Conclusion #2: Reporting required IRC § 408(i)
  - Report on Form 1099-R, showing the Individual as recipient of payment

Rev. Rul. 2018-17 (cont.)

- Reliance on special rule for traditional IRAs in IRC §3405(e)
- Not apply to payments made before the earlier of:
  - January 1, 2020, or
  - the date it "becomes reasonably practicable" for the payor to comply
- Not addressed: Roth IRAs, SEP IRAs, SIMPLE IRAs & deemed IRAs
- Qualified plans and IRC § 403(b) plans
  - DOL: ERISA preempts transfers mandated under state unclaimed property laws
  - DOL has approved sending assets of missing participants to a state in connection with a terminated DC plan
- Implications for non-qualified annuity contracts

Investment Advisory Fees

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Background

- In general
  - Policyholder of a deferred annuity chooses a third party advisor
  - Advisor provides advice and services relating to the contract
  - A fee is charged against the account value and paid to the advisor
  - Old model, but becoming more common
- Qualified plans, IRC § 403(b) contracts, and IRAs
  - Account / annuity contract was "solely liable" for paying the fee
  - The fee is an expense of the arrangement
  - The assessment of the fee does not constitute a distribution
  - See PLR 9845003 (Aug. 3, 1998), PLR 9047073 (Aug. 30, 1990), PLR 8951910 (Sep. 18, 1989), PLR 9005010 (Nov. 2, 1989)

Different Treatment for Non-Qualified Annuities

- Only one ruling – PLR 9342053 (Jul. 28, 1993)
- Facts indistinguishable from “qualified” arrangements
- IRS was adverse
  - The fee is an expense of the policyholder for services the advisor provided to the policyholder
  - The fact that the contract was solely liable for the fee does not “convert” the fee into an expense of contract
  - The policyholder is the only party directly benefiting from the advisor’s services
  - The assessment of the fee constitutes an amount received that is includible in gross income under IRC § 72(e) (income-first rule)
- Why the different (worse) result?

Life Product Tax Update

Life Product Tax – What's New?

Answer – both very little and a whole lot!

- From a 7702/A standpoint, it has been quiet

- All of the industry is working hard towards the 12/31/19 change products to use 2017 CSO mortality.

Coming Soon: Inforce Policy Owners will have problems that require actuarial help to solve.

Late Duration Policy Administration

Beyond inforce policy values and the growing needs of a mature block, there are associated product tax issues that need consideration

- GPT Funding Issues on UL Policies
  - UL Policies – Guideline Premium Forceouts
  - UL Policies – Lapse protection under 7702(f)(6)

- Age 100 Maturity and Extension of Benefits

Guideline Premium Test Funding Issues

Guideline Test Funding Issues on UL

- Many policies were originally sold at much higher interest rates and have underperformed as rates have declined.
- Owners are much older and have less financial flexibility

Result: Policyowners tend to do one of two things that can be problematic under GPT Limits:

1. Will try to *reduce benefits* and trigger a GPT Forceout
2. They try to *increase funding*, but be subject to a GPT limit.

Guideline Premium Forceouts 7702(f)(7)(A)

"What Goes Up Must Come Down"

"If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under [section 7702]."

- Known as attained age adjustment rule
- Adds attained age-based guideline premiums at time policy benefits increase, subtracts them at time benefits decrease
- Disregards sufficiency (or not) of current funding of policy

Guideline Forceout (continued)

Because adjustments are on the Attained Age of the insured, a decrease in benefits may have a disproportionately larger drop in the Guideline Premiums

<u>If GPT Limit drops below the Sum of Premiums Paid (SOPP), then a Forceout withdrawal of cash value is required.</u>

Why are Forceouts Important?

- Cause: Forceouts can be from Face Reductions, Withdrawals, or a Combination of transactions.
- Timing: Benefits reduce now, but forceouts often occur later.
- Irreversible: If take reduction now, may not qualify for a benefit increase later to offset required forceouts (and may be very expensive).
- Possible taxation: Forceouts are withdrawals, and would be taxable if the policy were a MEC, or if policyowner previously removed cost basis.
- Loss of benefits: Forceouts can cause policies to lapse.

Guideline Forceout Example
"Mrs. Olsen"

At Policy Issue

- Face Amount = $750,000, Age 45 at issue
- Paid $10,000/year for 15 years to age 60
- Had initial GPT Limits of $150,000 (GSP) and $15,000 (GLP).
- Extended payments another 5 years to age 65; $200,000 total premiums

30 Years Later: Options to help with low interest rates

1. Reduce Benefits 50% to $375,000. Forceouts begin age 90, with illustrated lapse age 92.
2. Reduce benefits to $465,000 to avoid forceouts, but at extra cost.
3. Reduce face to $350,000. Forceouts will return all cost basis (also with illustrated lapse).

What is the Role of the Actuary?

Communication – How to explain difficult (and painful) mathematics

1. Illustrations may lapse before forceout
2. Communications to Clients and Agents are difficult
3. Forceouts are in the future – why worry now?
4. Or, why have you not told me before?

Doing the Math:

1. Can the system do the calcs, and are specs needed?
2. Who can review policies and supply alternatives?

Guideline Premium Exception 7702(f)(6)

"The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of [the GPT limitation] if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period)."

Does The Exception Help?

This exception may help, but it has 2 very stringent requirements:

1. The disregarded premium cannot "exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year"
2. the contract must "have no cash surrender value at the end of such extension period" (including cash value that serves as collateral for a policy loan)

What this means – <u>The owner is now paying for ART insurance</u>.

Premium Administration Considerations

- Premium Deposit Fund: May offer the best way to put money into the contract and get to the $0 cash value requirement

- Tracking: You will need to track these 'extra' premiums paid above the GPT Limit and reconcile them at year end, as such amounts must be reprojected and reassessed at the start of the next year.

- Loans - These are not considered in the Cash Value requirement; thus the owner would first have to repay loans.

- Forceouts - The same exception applies to GPT Forceouts – these should not trigger a policy lapse, but again only to a $0 cash value

What is the Role of the Actuary?

Communication:

- Explanation of the Premium Exception and limits on the policy values and funding.
- Explanation of the increasing ART costs.

Doing the Math

- Can your system (illustration and admin) support the exception, including the $0 cash value requirement?
- Example – does the illustration project minimum premiums under the exception rule, or does it show a policy lapse?

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Living to Age 100

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Living to Age 100
Extension of Benefits

Policies are starting to live to the ‘maturity’ of their contract (i.e. age 100).

As this grows – there will be a need to consider what can or cannot be done to assist older owners:

- Contract Provisions – What benefits are provided?
- What limits and constraints (including tax) are present?
- Are there solutions or benefits that can be offered to owners to help with their financial needs?

Fact: There is not a one-solution-fits-all answer for any company.

“Tax Regimes” and Grandfathering

Contracts are not all the same.

One important way to group them are by the provisions of the tax code that govern them.

Time Period	Key description
< 1982 : Pre-TEFRA	No premium limits
1982-1984: TEFRA	Limits on UL only
1985-1988: DEFRA	No 7-pay, No “reasonableness”
1988-2008: TAMRA/ 80CSO	Introduced Reasonableness
2009-2019: TAMRA / 2001CSO	Allows post-age 100; Grandfather 80CSO
2020-?: TAMRA / 2017CSO	Grandfather 80CSO and 2001CSO

Contract Provisions

- Contract language has to guide the solution
- But contract language varies by Regime (e.g. 2001CSO to age 120), and by company practice.

Some key questions to ask?

- Does it state a Maturity (we pay Face at age 100; We pay CSV at age 100)?
- Is it Silent? If so, what is the correct interpretation?
- Does it not provide for a maturity (e.g. 2001CSO and later)? Do these contracts allow for funding to prevent lapsation?

Potential Product Tax Issues

- Tax Reporting on any payments actually made
- Material Change in contract terms
  - If a benefit is added that changes the contract's terms or guarantees, does it "deem" an exchange of the contract for tax purposes?
  - Could this cause a loss of grandfathering under a "tax regime"?
- Loss of Grandfathering of 1980 or 2001CSO Rates
- Monitoring Premiums paid post-age 100 to frozen limits
- 7-Pay reduction in face amount still applies

Possible Pricing Issues

- Timing: Is it better to lock in benefits now, or is it something that should be implemented later? Does this affect the cost?

- Extending benefits
  - If the Death Benefit does not drop, it is an extension of the Net Amount at Risk without underwriting
  - Do you still have a NAR?

- Reinsurance – does your reinsurance consider extending the benefits

- Reserves – How will you reserve for an extension of benefits

What is the Role of the Actuary?

- Complex Problem Infers Complex Solution
- Have to balance Pricing, Legal and Tax issues; no one group can solve this alone.
- Implementation
  - What are the system's limitations and what specs are needed
  - Communications of technical issues internally and externally