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Proposed Regulations on Reporting Requirements for Transfers for Value of Life Insurance Contracts

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On March 22, 2019, the Internal Revenue Service (“IRS”) and the Department of the Treasury (“Treasury”) issued proposed regulations regarding federal tax reporting of transfers for value of life insurance contracts and certain other transactions under section 6050Y,¹ which was added to the Internal Revenue Code (“Code”) by the so-called Tax Cuts and Jobs Act of 2017 (“TCJA”).² These proposed regulations also address modifications to the transfer-for-value rule of section 101(a)(2) that were made by the TCJA. In this article, we provide an overview of the key points addressed by the proposed regulations, and we briefly address comments requested by IRS/Treasury and comments submitted by the insurance industry and other interested parties.

OVERVIEW

Section 6050Y imposes tax reporting requirements in connection with certain transfers of life insurance contracts, which can be summarized as follows:

- **Acquirer reporting upon a reportable policy sale (“RPS”).** First, upon a “reportable policy sale,” within the meaning of section 101(a)(3)(B), the acquirer of a life insurance contract (or an interest therein) must file an information return with the IRS and furnish written statements to the issuer of the contract and to each “reportable policy sale payment recipient” reporting certain information with respect to the RPS.³ The proposed regulations refer to the statement furnished to the issuer as a “reportable policy sale statement,” or “RPSS.”⁴
- **Issuer reporting upon RPS.** Second, upon receipt of the RPSS from the acquirer or upon notice of a transfer of a life insurance contract to a foreign person, the issuer of the contract must file an information return with the IRS and furnish a statement to the seller reporting the “investment in

the contract” within the meaning of section 72(e)(6) and certain other information with respect to the RPS or transfer.⁵

- **Issuer reporting of reportable death benefits.** Third, when a “reportable death benefit” within the meaning of section 6050Y(d)(4) is paid, the issuer must file an information return with the IRS and furnish a statement to each “reportable death benefits payment recipient,” reporting certain information, including an estimate of the buyer’s investment in the contract.⁶

The TCJA also modified the transfer-for-value rule of section 101(a)(2). Under this rule, where there has been a transfer for value, the exclusion from income for life insurance death benefits generally is limited to the consideration the transferee pays for a contract. However, this limitation generally does not apply to a transfer where (1) the transferee’s basis in the contract is determined in whole or in part by reference to the transferor’s basis in the contract (referred to herein as the “Carryover Basis Exception”)⁷ or (2) the transfer is to the insured, 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 (referred to herein as the “Related-Party Transfer Exception”).⁸ The TCJA added section 101(a)(3) to the Code, which provides that these two exceptions to the limitation on the death benefit exclusion will not apply to a transfer of a life insurance contract, or any interest therein, which is a “reportable policy sale.” An RPS, in turn, is defined as “... the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer’s interest in such life insurance contract.”¹⁰ Section 101(a)(3) also clarifies that for purposes of this definition, the term “indirectly” “applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.” These changes to the transfer-for-value rule apply to transfers after Dec. 31, 2017.¹¹



Prior to the issuance of the proposed regulations, the IRS provided guidance in Notice 2018-41.¹² A discussion of such guidance is set forth in the sidebar to the article “The Life Insurance Product Tax Provisions of H.R. 1,” which was published in the June 2018 issue of *TAXING TIMES*.¹³

PROPOSED REGULATIONS ON SECTION 6050Y REPORTING REQUIREMENTS

As noted, the TCJA enacted section 6050Y, which imposes a tax reporting regime on acquirers of life insurance contracts (with reporting on Form 1099-LS at the time of the acquisition) and issuers of life insurance contracts (with reporting on Form 1099-SB at the time of the acquisition or transfer to a foreign person and on Form 1099-R or Form 1042-S when “reportable death benefits” are paid). Each of these reporting requirements will be discussed in turn.

Acquirer Reporting (Form 1099-LS)

The proposed regulations require a person that acquires a life insurance contract (directly or indirectly) in an RPS to file an information return with the IRS and furnish a statement to certain parties reporting specific information relating to the acquisition. The information required to be reported under the proposed regulations largely mirrors the statute: identifying information about the acquirer, the payment recipient and the contract issuer, along with the policy number, the date of the RPS and the amount of the payment.¹⁴ The proposed regulations define a number of terms for this purpose:

- **RPS payment.** The amount of the payment to be reported includes not only cash transferred in exchange for the life insurance contract, but also the fair market value of any other consideration, including debt assumed by the acquirer.¹⁵ Further, the definition includes amounts “transferred, or to be transferred,” in an RPS; the preamble clarifies that RPS payments to be made in installments are all reportable in the year of the RPS and that RPS payments reported with respect to the seller include only the amount transferred to the seller, including debt assumed, but would not include amounts retained by a broker or other intermediary.¹⁶
- **RPS payment recipient.** Under the proposed regulations, the term “recipient of payment” in the statute is read broadly to include brokers and other intermediaries, in addition to the seller.¹⁷ The acquirer is required to file a separate information return for and furnish a separate statement to each such recipient, showing that recipient’s portion of the proceeds. As IRS/Treasury observed in the preamble to the proposed regulations, this broad definition does not necessarily follow comments received in response to Notice 2018-41, but the matter is still under consideration and IRS/

Treasury requested additional comments, particularly with respect to ancillary costs and expenses.¹⁸

- **Issuer.** The proposed regulations define “issuer” differently depending on the particular reporting requirement being discussed. For purposes of the acquirer’s reporting under section 6050Y(a), the “6050Y(a) issuer” is the issuer responsible for administering the contract, including collecting premiums and paying death benefits, on the date of the RPS.¹⁹

In addition to filing Form 1099-LS with the IRS and furnishing statements to the RPS payment recipients, an acquirer that acquires a life insurance contract directly in an RPS is also required to furnish a statement (referred to as the RPSS) to the 6050Y(a) issuer with respect to the seller.²⁰ Notably, if the acquisition is indirect, the acquirer is not required to furnish an RPSS to the issuer,²¹ so an issuer may not have any knowledge of such an acquisition. Additionally, if the acquirer is a foreign person, the acquirer is only required to report with respect to an RPS if either the insured is a U.S. person at the time of the sale or the sale is subject to state laws (in U.S. states or the District of Columbia) pertaining to acquisitions or sales of life insurance contracts or interests therein.²²

For an insurance company, the acquirer’s reporting requirements are important primarily because the Form 1099-LS notifies the company that an RPS has occurred, triggering the company’s own reporting obligations under sections 6050Y(b) and (c). While the regulations are in the process of being finalized, insurers should be considering operational aspects of the requirements, such as how to ensure that the Form 1099-LS is routed promptly to the proper team for processing, how the information from Form 1099-LS will be captured and stored, and how contracts that have been transferred in an RPS can be identified and tracked for subsequent reporting by the insurer.

Issuer Reporting at Acquisition (Form 1099-SB)

The statute and the proposed regulations require an issuer to report the seller’s basis when a contract is transferred in a reportable policy sale or to a foreign person. There are two separate triggers for the issuer’s reporting obligation:

- **Receipt of the RPSS, *i.e.*, Form 1099-LS.** Both the statute and the proposed regulations condition the issuer’s reporting obligation under section 6050Y(b) upon receipt of the RPSS from the acquirer (or upon notice of transfer to a foreign person, discussed next).²³ Thus, if an issuer does not receive Form 1099-LS or an appropriate substitute form, and there has been no notice of transfer to a foreign person, then the issuer presumably does not have an obligation to report under section 6050Y(b).

- **Receipt of notice of transfer to a foreign person.** If the acquirer or transferee is a foreign person, both the statute and the proposed regulations require reporting by the issuer upon notice of a transfer to a foreign person;²⁴ there is no IRS-designated form for providing such notice. The legislative history of the TCJA indicates that Congress intended this trigger to be quite broad:

Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for non-tax 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.²⁵

Appropriately, the proposed regulation narrows the concept slightly to clarify that there must be a “transfer of title to, possession of, or legal ownership of” the contract, but the proposed regulation then goes on to state that notice includes information provided for nontax purposes (such as a change of address for purposes of sending statements or with respect to loans, premiums or death benefits) “unless the 6050Y(b) issuer knows that no transfer of the life insurance contract has occurred or knows that the transferee is a United States person.”²⁶ In this regard, the proposed regulations provide that if an issuer has a Form W-9 or valid substitute form indicating that the transferee is a U.S. person and providing a U.S. taxpayer identification number, the issuer may rely on this to conclude there has been no transfer to a foreign person.²⁷

The statute and the proposed regulations also require an issuer to report “reportable death benefits.”

Regardless of which trigger applies, the issuer will be required to file and furnish Form 1099-SB, containing identifying information about the seller, the policy number and the “investment in the contract” as defined in section 72(e)(6) with respect to such seller, as well as the “amount the seller would have received if the seller had surrendered the life insurance contract on the date of the [RPS] or the transfer of the contract to a foreign person.”²⁸ The surrender value is not specifically enumerated in section 6050Y(b)(1). As discussed in the preamble to the proposed regulations, the IRS and Treasury concluded that reporting this value both to the seller and to the IRS is required in order to properly identify the portion of gain that is ordinary income (*i.e.*, the excess of the contract’s surrender value over the

seller’s basis) and the portion, if any, that is capital gain (*i.e.*, any proceeds from the sale in excess of the surrender value).²⁹

If the seller was the original owner of the contract, the issuer would generally have information on file to compute the seller’s investment in the contract properly under section 72(e)(6). If the contract has been previously transferred (in an RPS or otherwise), the issuer may not have such information. The proposed regulations accommodate this by requiring the issuer to provide the “estimate of investment in the contract” with respect to a person other than the original policyholder, with such estimate defined on any date as “the aggregate amount of premiums paid for the contract by that person before that date, less the aggregate amount received under the contract by that person before that date to the extent such information is known to or can reasonably be estimated by the issuer or payor.”³⁰ Note that the definition does not include the purchase price that a buyer paid for the in-force contract; generally, an insurer will not be privy to that information. Note also that the “aggregate amount received under the contract” in the estimate is not limited to the portion that was excludable from gross income, as would normally be the case under section 72.³¹ In both respects, the estimate will tend to understate the taxpayer’s actual basis, and the onus will be on the taxpayer to properly compute his or her basis and taxable income.

One final observation on the issuer’s reporting obligation at acquisition relates to the identification of the issuer. As noted previously, the definition of “issuer” in the proposed regulations depends on the context, but the general definition includes “any person that bears any part of the risk with respect to the life insurance contract on that date and any person responsible on that date for administering the contract, including collecting premiums and paying death benefits.”³² This explicitly includes a reinsurer that has reinsured all or a portion of the risks of a contract through an indemnity reinsurance treaty.³³ Although the proposed regulations helpfully provide for unified reporting, allowing one issuer to satisfy the reporting obligations of all issuers with respect to section 6050Y(b) reporting for a contract,³⁴ the inclusion of indemnity reinsurers in the definition may create additional administrative complications and penalty exposure for entities that typically do not have access to the information needed for such reporting.³⁵

Issuer Reporting at Death (Forms 1099-R and 1042-S)

The statute and the proposed regulations also require an issuer to report “reportable death benefits,” defined as “amounts paid by reason of the death of the insured under a life insurance contract that are attributable to an interest in the life insurance contract that was transferred in a reportable policy sale.”³⁶ The information to be reported after death includes identifying

information about the payor and recipient, the date of the payment, the gross amount of payments made to the recipient, and the payor's estimate of the investment in the contract with respect to the buyer.³⁷

The IRS has updated the 2018 and 2019 Form 1099-R and associated instructions to accommodate reporting under section 6050Y(c). This includes a new distribution code, code C, and a new field for the date of the payment.³⁸ Additionally, the instructions appear to allow companies to check the "Taxable amount not determined" box and leave the "Taxable amount" (Box 2a) blank for reportable death benefits, although the estimate of the investment in the contract must always be included in Box 5.³⁹

The IRS has also updated the 2019 Instructions for Form 1042-S to include a new income code, providing the following guidance: "Use code 55 (taxable death benefits on life insurance contracts) to report taxable death benefits, such as benefits paid on an insurance contract that was acquired on a transfer for valuable consideration. See section 101 for when death benefits are taxable."⁴⁰ Interestingly, the instructions do not refer to "reportable death benefits" but rather the broader term

"taxable death benefits." This arguably reflects the possibility that certain death benefits reportable under Treas. Reg. section 1.1461-1 may not be "reportable death benefits" as defined by section 6050Y(d)(4).

Summary of Proposed Reporting Requirements

Figure 1 summarizes the reporting requirements described earlier, including the deadlines for reporting of events that occur after final regulations are published.⁴¹

For transition relief, the proposed regulations provide transition deadlines for reporting on transactions occurring after Dec. 31, 2017, and before the date final regulations are published in the Federal Register. For an RPS occurring during that transition period, the acquirer must furnish the RPSS (Form 1099-LS) to the issuer by 60 days after the date final regulations are published in the Federal Register (or the applicable date from Figure 1, if later).⁴³ For all other information returns to be filed with the IRS or furnished to RPS payment recipients, sellers, transferors or reportable death benefits payment recipients, the transition deadline is 90 days after the date final regulations are published in the Federal Register (or the applicable date from Figure 1, if later).⁴⁴

Figure 1
Summary of Proposed Reporting Requirements

Direct RPS		To			Indirect RPS ^d		To		
		Insurer ^a	Recipient / Seller	IRS			Insurer	Recipient	IRS
From	Acquirer	1099-LS / RPSS Jan. 15 at latest ^b	1099-LS Feb. 15	1099-LS Feb. 28 ^c	From	Acquirer		1099-LS Feb. 15	1099-LS Feb. 28 ^c
	Insurer		1099-SB Feb. 15	1099-SB Feb. 28 ^c		Insurer			
Transfer to foreign person		To					To		
		Transferor					IRS		
From	Insurer		1099-SB Feb. 15 ^e	1099-SB Feb. 28 ^{c,e}					
Reportable death benefits: U.S.		To			Taxable death benefits: foreign person ^f		To		
		Recipient / Beneficiary					Recipient / Beneficiary		
From	Insurer		1099-R Jan. 31	1099-R Feb. 28 ^c	From	Insurer		1042-S Mar. 15	1042-S Mar. 15

a. The "Insurer" represents the 6050Y(a) issuer, 6050Y(b) issuer and payor of reportable death benefits.
b. The RPSS must be furnished to the 6050Y(a) issuer by the later of 20 calendar days after the RPS, or five calendar days after the end of the applicable state law rescission period, but in no event later than Jan. 15 of the year following the calendar year in which the RPS occurred.
c. If Form 1099-LS, 1099-SB or 1099-R is filed with the IRS electronically, the deadline for such electronic filings is Mar. 31. Other extensions may also be available.
d. That is, an RPS for which the acquirer is not required to, and does not, provide an RPSS pursuant to Prop. Reg. section 1.6050Y-2(d)(2)(B). If the insurer receives an RPSS for an RPS that was made indirectly, then the insurer would apparently file and furnish Form 1099-SB following the "Direct RPS" section of this chart.
e. If the issuer does not receive notice of transfer to a foreign person until after Jan. 31 of the year following the transfer, the proposed regulations allow 30 days after the date notice is received.⁴²
f. Taxable death benefits to foreign persons include reportable death benefits and any death benefits for which reporting is otherwise required, such as under Treas. Reg. section 1.1461-1.

PROPOSED REGULATIONS ON THE TRANSFER-FOR-VALUE RULE

As noted, if a life insurance contract is transferred for value, the exclusion from income under section 101 for the death benefit generally is limited by the transfer-for-value rule of section 101(a)(2) to the sum of the consideration paid by the transferee for the contract and the premiums and other amounts subsequently paid by the transferee for the contract.⁴⁵ Also, reflecting new section 101(a)(3), the proposed regulations provide that the Carryover Basis Exception and the Related-Party Transfer Exception to the transfer-for-value rule's limitation on the amount of the excludable death benefit will not apply if the transfer is an RPS.⁴⁶ Thus, ascertaining whether a transfer should be characterized as an RPS is a threshold inquiry in determining whether the exclusion for death benefits under section 101 will be limited by section 101(a)(2)'s transfer-for-value rule. The proposed regulations also provide other guidance and clarifications relating to the Carryover Basis and Related-Party Transfer Exceptions that are noteworthy. We next examine each of these points in turn.

Reportable Policy Sale (RPS) Definition

Mirroring the statutory definition in section 101(a)(3)(B), the proposed regulations generally define an RPS as "... any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract."⁴⁷

The proposed regulations address the scope of RPSs in part by defining the phrase "interest in a life insurance contract" and also by defining "direct" and "indirect" acquisitions of an interest in a life insurance contract.⁴⁸ For example, an "indirect" acquisition of an interest in a life insurance contract occurs when "a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest in the life insurance contract."⁴⁹ Significantly, the proposed regulations state that, for this purpose, the term "other entity" "does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts...."⁵⁰ Thus, purchasing stock in a C corporation with life insurance holdings that do not meet this threshold would not be an RPS with respect to that stock purchaser, and a transfer of the contract by a C corporation that does not meet this threshold would not be an indirect transfer of the contract by the C corporation's shareholders.

The proposed regulations also clarify that naming a revocable beneficiary is not a transfer of an interest in a life insurance contract; in contrast, an irrevocable beneficiary designation would be such a transfer.⁵¹ Also, the preamble to the proposed

regulations clarifies that the granting of an enforceable right to name the beneficiary is a transfer of an interest in a contract.⁵² Further, the assignment or pledge of a contract as a collateral assignment is not a transfer of an interest in the contract.⁵³ In addition, the issuance of a life insurance contract is not treated as a transfer of an interest in the contract, "other than the issuance of a policy in an exchange pursuant to section 1035."⁵⁴ (The preamble to the proposed regulations requested comments on "[w]hether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts." In this regard, the ACLI comment letter indicated that, in light of the definition of an RPS, an acquirer would be unlikely to meet insurable interest requirements with respect to an insured and thus would be unlikely to be able to purchase a new policy in exchange for a policy that had been acquired in an RPS. The ACLI thus recommended that no additional provisions be added to the regulations for this circumstance.)

The proposed regulations also include two groups of situations where a transfer of a contract is not an RPS: The first group is a list of specific transactions that will not be treated as RPSs. The second group addresses transfers where the acquirer will be considered to have at the time of the acquisition a *substantial* family, business, or financial relationship with the insured, which based on section 101(a)(3) are not treated as RPSs.

The proposed regulations clarify that naming a revocable beneficiary is not a transfer of an interest in a life insurance contract.

Specific Transactions That are not Treated as RPSs

The proposed regulations specify that the following transfers of interest in life insurance contracts are not RPSs:

- A transfer between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity.⁵⁵ For this purpose, if there is a series of transfers, this exception is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity.⁵⁶ Also, where a trust's beneficial ownership of a life insurance contract is involved, the ownership interest of each beneficial owner of the trust is determined by the broadest possible exercise of a trustee's discretion in the beneficial owner's favor.⁵⁷

- A transfer between corporations in the same affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.⁵⁸
- The indirect acquisition of an interest in a life insurance contract if the entity that directly holds the interest acquired it in an RPS that was reported as required by section 6050Y(a) and Treas. Reg. section 1.6050Y-2.⁵⁹
- The indirect acquisition of an interest in a life insurance contract if, prior to the acquisition, no more than 50 percent of the gross value of the assets of the partnership, trust, or other entity directly holding the interest consists of life insurance contracts, and with respect to that entity, the person indirectly acquiring the interest in the contract (acquirer) and his or her family members own no more than a 5 percent interest.⁶⁰ Whether a 5 percent interest is held must be determined based on total combined voting power and value of all classes of stock (for S corporations), corpus and annual income rights, assuming the maximum corpus and income that can be distributed for the benefit of the acquirer and his or her family members (for trusts), and capital and profits interests (for partnerships and other noncorporate/nontrust entities).⁶¹ As noted above, an indirect transfer of an interest occurs with respect to a C corporation only where more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts.⁶² As noted earlier, where less than 50 percent of gross value consists of such contracts, a transfer of a contract by such a C corporation would not be treated as an indirect transfer of that contract by the corporation's shareholders. (A transfer of a contract by a shareholder to a C Corporation could, however, be an RPS.)⁶³⁶⁴

Transactions Where the Acquirer is Considered to Have a Substantial Family, Business, or Financial Relationship With the Insured

As noted, the second group of transfers that are not treated as RPSs are transfers where the acquirer is considered, at the time of the acquisition, to have a substantial family, business, or financial relationship with the insured. The proposed regulations provide more specific rules for these “substantial” relationship exceptions to RPS treatment, as follows:

- **Substantial family relationship.** The following “family members” have a substantial family relationship with the insured: spouse (including a registered domestic partner and civil union); parents, grandparents and great-grandparents of the individual and spouse; and lineal descendants of any of these individuals and their spouses (and the lineal

descendants of such spouses).⁶⁵ A substantial family relationship also exists where there is a transfer to (or in trust for) a former spouse incident to divorce.⁶⁶ Further, a substantial family relationship generally exists between an insured and family partnerships or family trusts if all beneficial owners of those entities have a substantial family relationship with the insured.⁶⁷

- **Substantial business relationship.** The insured has a substantial business relationship with a trade or business where the insured “is a key person ... of, or materially participates ... in, an active trade or business as an owner, employee, or contractor, and at least 80% of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer.”⁶⁸ Also, if certain requirements are met, a substantial business relationship exists where the acquirer acquires a life insurance contract in connection with the acquisition of an active and continuing trade or business (that does not involve investments in life insurance contracts) and the insured is an employee, director or highly compensated individual of such trade or business.⁶⁹
- **Substantial financial relationship.** The acquirer has a substantial financial relationship with the insured if the acquirer, directly or indirectly, has “a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured’s interest in the common investment by the co-investor(s) after the insured’s death is reasonably foreseeable.”⁷⁰ A substantial financial relationship also exists where the acquirer maintains the life insurance contract to “provide funds to purchase assets or satisfy liabilities following the death of the insured.”⁷¹ In addition, a substantial financial relationship exists where the acquirer is a charitable organization meeting certain criteria that previously received financial support in a substantial amount or significant volunteer support from the insured.⁷²

With respect to the latter two types of “substantial” relationships, an acquirer of an indirect interest in a life insurance contract is deemed to have a substantial business and financial relationship with the insured if the direct holder of the interest has a substantial business or financial relationship with the insured immediately before and after the acquisition of that indirect interest.⁷³ Being a partner of the insured or a partnership in which the insured is a partner does not in and of itself establish a substantial business or financial relationship with the insured.⁷⁴ The same is the case where the acquirer is a corporation and the insured is a shareholder or officer.⁷⁵ At the same time, these types of relationships are not prerequisites to the existence of a “substantial” relationship with the insured.⁷⁶

Application of Exceptions to Transfer-for-Value Rule

In circumstances where a transfer is not an RPS, the proposed regulations include a number of additional rules for the Carryover Basis and Related-Party Transfer Exceptions. The proposed regulations indicate that the Carryover Basis Exception will apply only if the Related-Party Transfer Exception does not apply.⁷⁷ Where the Carryover Basis Exception applies, the death benefit proceeds that are excludable from income under section 101(a)(1) is limited to the amount that would have been excludable by the transferor (had the transfer not occurred) and the premiums and other amounts subsequently paid by the transferee.⁷⁸ This limitation applies regardless of whether there has been a prior transfer and the nature of prior transfers.⁷⁹ Further, with respect to the Related-Party Transfer Exception, the proposed regulations state that this exception is available only if the interest in the life insurance contract was not previously transferred in an RPS.⁸⁰ However, the proposed regulations provide that if the exception would have been available but for a prior transfer that was an RPS, then the death benefit proceeds that are excludable from income under section 101(a)(1) is limited to the higher of the amount that would have been excludable by the transferor (had the transfer not occurred) or the value of consideration paid by the transferee, plus the premiums and other amounts subsequently paid by the transferee.⁸¹

Due to these rules, even if a transfer avoids characterization as an RPS, the transfer nonetheless may constitute a transfer for value for which neither the Carryover Basis Exception nor the Related-Party Transfer Exception applies. As an illustration of this point, Example 1 of Prop. Reg. section 1.101-1(g)(1) addresses the treatment of a sale of a life insurance contract originally owned and covering a father (A) to his son (B) for the contract's fair market value and concludes that the transfer-for-value rule limits the exclusion from income when the death benefit is paid to B. The Carryover Basis Exception does not apply in this example because the basis of B's interest is not determined in whole or in part by reference to the basis of the interest in the hands of the transferor, A. Also, the Related-Party Transfer Exception does not apply, since B is not 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.

Example 3 of Prop. Reg. section 1.101-1(g)(3) modifies Example 1 by assuming that the son, B, sells the contract back to A for the contract's fair market value. Because the transfer is to the insured, the Related-Party Transfer Exception applies under this fact pattern, and thus the exclusion from income under section 101 is not limited by the transfer-for-value rule.⁸² Example 5 of Prop. Reg. section 1.101-1(g)(5) is similar in that the contract is originally purchased by (and covers) A, is sold to another person (in this case, C, an unrelated person) and is eventually repurchased by A for its fair market value. Here, the Related-Party

Transfer Exception does not apply since the transfer of the contract to C was an RPS, and thus the transfer-for-value rule limits the exclusion from income to the sum of (1) the higher of the amount C could have excluded (had the transfer back to A not occurred) or the actual value of the consideration for that transfer paid by A, and (2) any premiums and other amounts paid by A after the transfer back to A.⁸³

Gratuitous Transfers

The proposed regulations principally address transfers of a life insurance contract (or an interest therein) for valuable consideration, since that is the circumstance where the section 101(a)(1) exclusion from income for the death benefit is limited. However, the proposed regulations also include a rule for gratuitous transfers, and they assert that in some circumstances such transfers could be RPSs. For all gratuitous transfers of an interest in a life insurance contract, including any that might be RPSs, the proposed regulations state that the exclusion from income is limited to the sum of the amount of the proceeds that would have been excludable by the transferor (had the transfer not occurred) and the premiums and other amounts subsequently paid by the transferee.⁸⁴ If a transfer is in part for valuable consideration and in part gratuitous, each part is treated as a separate transaction and is subject to the rules applicable to the transfers of the respective parts.⁸⁵

Example 6 of Prop. Reg. section 1.101-1(g)(6) extends Example 5, but assumes that C gratuitously transferred the contract back to A (the original owner and covered insured who previously transferred the contract to C in an RPS). On these facts, the Related-Party Transfer Exception does not apply, since the transfer of the contract to C was an RPS. Also, the exclusion limitation equals the amount C could have excluded (had the transfer back to A not occurred) plus the premiums and other amounts paid by A after the gratuitous transfer back to A.⁸⁶

The ACLI comment letter questioned the appropriateness of imposing reporting requirements for gratuitous transfers. The ACLI pointed out that the transfer-for-value rule applies only where there is a "transfer for valuable consideration" and said that this limitation on scope extended to the RPS definition as a matter of statutory construction; the ACLI also expressed concern about taxpayer confusion from tax reporting for transactions that do not result in the realization of income.⁸⁷

Health Insurance Death Benefits

In addition to the previously described changes, the proposed regulations under section 101 make further modifications to existing regulations to reflect changes in the law. In this regard, the preamble to the proposed regulations states that these changes "update § 1.101-1(a)(1) of the existing regulations to reflect ... the addition of section 7702 (definition of life

insurance contract) in 1984 [and] section 101(j) (treatment of certain employer-owned life insurance contracts) in 2006...”⁸⁸ These changes include the elimination of the following sentence from Treas. Reg. section 1.101-1(a)(1), which has been part of that regulation since 1957: “Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen’s compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision.”⁸⁹

While the enactment of section 7702 adopted a comprehensive definition of “life insurance contract” for tax purposes, there is no specific indication in the legislative history of that enactment that Congress intended to reverse the tax treatment of death benefits from health insurance contracts that were within the ambit of this provision. Further, although the proposed deletion is based on the premise that this sentence is merely deadwood, this does not appear to be the case. It is fair to observe, for example, that insurance contracts sometimes include combinations of different types of coverage, one of which could be health insurance and another of which could be life insurance coverage. State regulation may focus on the predominant coverage as a matter of convenience, but this does not change the nature of the nondominant coverage. If the nondominant coverage constitutes life insurance under state or other governing law (*i.e.*, “applicable law” within the meaning of section 7702(a)) and the contract by its terms has no cash value (and thus would satisfy the cash value accumulation test of section 7702(b)), it certainly seems that the death benefit of the life insurance portion of the contract would be excludable under section 101.⁹⁰ Life insurance death benefit treatment also may be appropriate for death benefits provided under some employer group health insurance contracts. Ascertaining when a life insurance benefit should be treated as satisfying the “applicable law” standard is a complicated question that depends on the facts and state law regime. In these circumstances, it seems that the original sentence should be retained in the regulations.⁹¹

Requests for Comments

In the preamble to the proposed regulations, Treasury and the IRS set forth an enumerated request for comments on the following topics:

1. electronic statements,
2. the timing of payments and ancillary costs relating to RPSs (and existing reporting requirements for payments),
3. whether only issuers should be considered payors of reportable death benefits,
4. whether a substantial business relationship or substantial financial relationship should be considered to exist between

the acquirer and insured in circumstances not included in the proposed regulations,

5. whether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts, and
6. whether the exceptions to reporting by 6050Y(b) issuers and payors under Prop. Reg. sections 1.6050Y-3(f)(1) and 1.6050Y-4(e)(1) (covering sellers and reportable death benefit payment recipients documented as foreign beneficial owners) are appropriate, and also whether the proposed reporting requirements are duplicative or could be combined with other reporting requirements.⁹² (Written or electronic comments were due by May 9, 2019.)

Effective Date

For purposes of section 6050Y, the proposed regulations generally apply to RPSs occurring after Dec. 31, 2017, and to reportable death benefits paid after Dec. 31, 2017.⁹³ For other purposes, the proposed regulations generally apply to transfers of life insurance contracts (or interests therein) made after the date of publication of final regulations in the Federal Register.⁹⁴ The ACLI and the Association for Advanced Life Underwriting (“AALU”) requested clarification that the proposed regulations with respect to section 101(a)(3) could be relied upon for all transfers after Dec. 31, 2017.⁹⁵

CONCLUDING THOUGHTS

The proposed regulations offer helpful clarifications—for example, with respect to common corporate transactions that are not directed toward effecting a transfer for value of life insurance. It is of course necessary that the regulations appropriately implement the statute’s requirements, but congressional intent and the practical challenges faced by insurers and others in administering the new reporting regime also should be kept in mind. We encourage the IRS and Treasury to continue the dialogue with the various stakeholders in the process leading toward the issuance of final regulations. ■

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ENDNOTES

- 1 Except as otherwise noted, references herein to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
- 2 Pub. L. No. 115-97, title I, § 13520. The proposed regulations were published in the Federal Register on March 25, 2019. See 84 FR 11009 (March 25, 2019).
- 3 Code section 6050Y(a) and Prop. Reg. section 1.6050Y-2(a) and (d).
- 4 Prop. Reg. sections 1.6050Y-1(a)(17) and 1.6050Y-2(d)(2)(i).
- 5 Code section 6050Y(b) and Prop. Reg. section 1.6050Y-3.
- 6 Code section 6050Y(c) and Prop. Reg. section 1.6050Y-4.
- 7 Upon a sale of property, including a life insurance contract, taxable gain generally must be recognized under the rules of section 1001, and for this purpose gain equals the excess of the amount realized upon the sale over the taxpayer's adjusted basis in the property. Code section 1001(a); Rev. Rul. 2009-13, 2009-21 I.R.B. 1029. "Adjusted basis" is defined by section 1011 and generally equals the cost of the property to the taxpayer with certain adjustments. Where a taxpayer acquires property by gift, however, section 1015(a) generally provides that the taxpayer's basis upon the gift "shall be the same as it would be in the hands of the donor," subject to certain limitations and adjustments. Other examples where adjusted basis carries over from one taxpayer to another include section 362(a) and (b) (for certain contributions by a shareholder to a corporation and upon certain reorganizations), section 334(b) (relating to liquidations of corporations), and section 723 (for contributions by a partner to a partnership).
- 8 Code section 101(a)(2).
- 9 Code section 101(a)(3)(A).
- 10 Code section 101(a)(3)(B).
- 11 TCJA § 13522(c). In addition to the previously described changes, the TCJA clarified that the adjusted basis of a life insurance contract under section 1011, which is relevant to the tax treatment of sales and other dispositions of property under section 1001, is not reduced by "mortality, expense, or other reasonable charges incurred under [a] ... life insurance contract." TCJA § 13521(a). This amendment reverses the position the IRS had adopted regarding the treatment of mortality charges in Rev. Rul. 2009-13. The amendment is effective for transactions entered into after Aug. 25, 2009, which was the effective date of the revenue ruling. TCJA § 13521(b).
- 12 2018-20 I.R.B. 584.
- 13 John T. Adney, Brian G. King and Craig R. Springfield. The Life Insurance Product Tax Provisions of H.R. 1, *TAXING TIMES*, Vol. 14, Issue 2, at 30-39 (June 2018), <https://www.soa.org/globalassets/assets/library/newsletters/taxing-times/2018/june/tax-2018-vol-14-iss2.pdf> (accessed September 20, 2019).
- 14 Code section 6050Y(a)(1) and Prop. Reg. section 1.6050Y-2(a).
- 15 Prop. Reg. section 1.6050Y-1(a)(15).
- 16 84 FR 11009, 11010-11 (March 25, 2019); the latter amounts would instead be reportable to the broker or intermediary.
- 17 Prop. Reg. section 1.6050Y-1(a)(16).
- 18 84 FR 11009, 11011 (March 25, 2019). The Life Insurance Settlement Association ("LISA") submitted comments describing the many types of ancillary costs that may arise in an RPS, stating that such costs would already be reportable under section 6041 and requesting that they be excluded from the definition of RPS payments. Letter of Christopher Conway and Bryan Nicholson to IRS (May 8, 2019) (the "LISA comment letter"). The Institutional Longevity Markets Association ("ILMA") made a similar request. Letter of John Kelly to IRS (May 9, 2019) (the "ILMA comment letter").
- 19 Prop. Reg. section 1.6050Y-1(a)(8)(ii).
- 20 Prop. Reg. section 1.6050Y-2(d)(2). No reporting to the issuer is required with respect to brokers or other intermediaries; additionally the amount of the RPS payment made to the seller is not required to be disclosed to the issuer.
- 21 Prop. Reg. section 1.6050Y-2(d)(2)(i)(B).
- 22 Prop. Reg. section 1.6050Y-2(f). If the acquirer, insured, and governing law for the acquisition are all non-U.S., then presumably the IRS would not have jurisdiction to require information reporting by the acquirer.
- 23 Code section 6050Y(b)(1) ("Upon receipt of the statement required under [section 6050Y(a)(2)]") and Prop. Reg. section 1.6050Y-3(a) ("each 6050Y(b) issuer, that receives a RPSS").
- 24 Code section 6050Y(b)(1) and Prop. Reg. section 1.6050Y-3(a).
- 25 H.R. Rep. No. 115-466 (2017) (Conference Report) at 485.
- 26 Prop. Reg. section 1.6050Y-1(a)(10).
- 27 *Id.* The American Council of Life Insurers ("ACLI") submitted a comment letter requesting a number of clarifications and changes to the proposed regulations. One such request was to modify the definition of "notice of a transfer to a foreign person" to include only notices that contain foreign indicia (e.g., a foreign address or foreign taxpayer identification number). Letter from Regina Rose and Mandana Parsazad, ACLI, to Helen Hubbard, Alexis MacIvor, and Kathryn Sneade of the IRS and Angela Walitt of Treasury (May 9, 2019) (the "ACLI comment letter").
- 28 Prop. Reg. section 1.6050Y-3(a).
- 29 84 FR 11009, 11013 (March 25, 2019). See also Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, regarding the character of income realized upon sale of a life insurance contract. The preamble cites sections 6050Y(b)(1), 6011(a), and 7805 as providing authority for the IRS to require reporting of the surrender value. 84 FR 11009, 11013 (March 25, 2019).
- 30 Prop. Reg. section 1.6050Y-1(a)(7).
- 31 Code section 72(e)(6)(B). Note, however, that if the issuer is preparing a Form 1099-SB for the original policyholder, it should follow the regular rules under section 72(e)(6)(B).
- 32 Prop. Reg. section 1.6050Y-1(a)(8)(i).
- 33 *Id.*
- 34 Prop. Reg. sections 1.6050Y-3(b) and 1.6050Y-3(d)(3).
- 35 The ACLI comment letter recommended that the definition of issuer exclude "a reinsurer in an indemnity contract covering all or a portion of the risks that the original issuer (and continuing contract administrator) might otherwise have incurred with respect to a life insurance contract," as the IRS had originally proposed in Notice 2018-41.
- 36 Prop. Reg. sections 1.6050Y-4(a) and 1.6050Y-1(a)(12). See also Code sections 6050Y(c) and 6050Y(d)(4).
- 37 Code section 6050Y(c)(1) and Prop. Reg. section 1.6050Y-4(a).
- 38 It is unclear from the "Guide to Distribution Codes" chart in the current versions of the instructions (dated July 13, 2018, for the 2018 tax year and Dec. 18, 2018, for the 2019 tax year) whether code C is intended to be used with code 4. The charts do consistently reflect that the new code C may be used with code D (relating to the Medicare surtax on net investment income under section 1411), if applicable.
- 39 The ACLI comment letter also requests guidance on whether income tax withholding should be based on the gross payment or the net payment (i.e., the reportable death benefits less the issuer's estimate of investment in the contract).
- 40 2019 Instructions for Form 1042-S (Jan. 7, 2019).
- 41 See Prop. Reg. sections 1.6050Y-2(c) and (d), 1.6050Y-3(c) and (d), and 1.6050Y-4(b) and (c). Also see 2018 Instructions for Form 1099-LS (Feb. 19, 2019), 2019 Instructions for Form 1099-SB (Feb. 21, 2019), 2018 Instructions for Forms 1099-R and 5498 (July 13, 2018), and 2019 Instructions for Form 1042-S (Jan. 7, 2019).
- 42 Prop. Reg. sections 1.6050Y-3(c) and 1.6050Y-3(d)(2). This extension only applies to delayed receipt of notice of transfer to a foreign person. The ACLI comment letter requested that a parallel extension be granted if the issuer does not receive an RPSS until after Jan. 31 of the year following the RPS. Additionally, the ACLI comment letter requested broader, permanent penalty relief for issuers unable to meet the filing due date for reasons beyond the control of the issuer.
- 43 Prop. Reg. section 1.6050Y-1(b)(1).
- 44 Prop. Reg. section 1.6050Y-1(b)(2). The ACLI comment letter requested that the transition filing deadline for reporting under section 6050Y(b) and (c) be extended to 120 days, rather than 90 days, after final regulations are published in the Federal Register.
- 45 Prop. Reg. section 1.101-1(b)(1)(i).
- 46 Prop. Reg. section 1.101-1(b)(1)(ii)(A) and (B).
- 47 Prop. Reg. section 1.101-1(c)(1).
- 48 Prop. Reg. section 1.101-1(e).
- 49 Prop. Reg. section 1.101-1(e)(3)(ii).

- 50 *Id.* The methodology for determining the gross value of assets is set forth in Prop. Reg. section 1.101-1(f)(4). Where an entity is publicly traded, if the entity's Form 10-K does not contain information demonstrating that more than 50 percent of the entity's assets consist of life insurance contracts, one can assume (absent actual knowledge otherwise) that no more than 50 percent of the gross value of the entity's assets consist of such contracts. Prop. Reg. section 1.101-1(f)(4)(ii). Also, a safe harbor is provided under which the cash value of life insurance contracts and the adjusted basis of other assets may be used to identify gross value. Prop. Reg. section 1.101-1(f)(4)(iii).
- 51 Prop. Reg. section 1.101-1(e)(2).
- 52 84 FR 11009, 11016 (March 25, 2019).
- 53 Prop. Reg. section 1.101-1(e)(2).
- 54 *Id.*
- 55 Prop. Reg. section 1.101-1(c)(2)(i). This exception to RPS treatment is illustrated by Prop. Reg. section 1.101-1(g)(10), Example 10.
- 56 Prop. Reg. section 1.101-1(c)(2)(i).
- 57 *Id.*
- 58 Prop. Reg. section 1.101-1(c)(2)(ii).
- 59 Prop. Reg. section 1.101-1(c)(2)(iii)(A). The ILMA comment letter stated that this exception should apply to circumstances where the direct holder acquired its interest prior to 2018 and the entity otherwise reports properly with respect to contracts acquired after 2017. The LISA comment letter similarly requested relief where an investment vehicle has acquired life insurance contracts in transactions prior to 2018.
- 60 Prop. Reg. section 1.101-1(c)(2)(iii)(B). The gross value of assets is determined under the rules of Prop. Reg. section 1.101-1(f)(4). Also, the application of this 5 percent interest rule is illustrated by Prop. Reg. section 1.101-1(g)(12), Example 12.
- 61 Prop. Reg. section 1.101-1(c)(2)(iii)(B).
- 62 Prop. Reg. section 1.101-1(e)(3)(ii).
- 63 See, e.g., Prop. Reg. section 1.101-1(g)(9), Example 9.
- 64 The LISA comment letter requested the elimination of reporting for certain indirect investors, such as where such reporting would be duplicative, impractical or might not produce meaningful information. The LISA comment letter also requested that the reporting obligation not apply to investors in an investment vehicle who have a 5 percent or lesser economic and voting interest in that vehicle and who are not officers or directors of the vehicle. Further the LISA comment letter requested relief for situations where life insurance contracts are held directly by nominees or securities intermediaries, but the partnership or other entity in which investors beneficially invest in such contracts does not hold a direct interest in the contracts.
- 65 Prop. Reg. section 1.101-1(d)(1) and (f)(3).
- 66 Prop. Reg. section 1.101-1(d)(1).
- 67 *Id.* Michael L. Van Cise, Esq., submitted a comment letter in which he questioned the need of requiring that all beneficial owners have a substantial family relationship, such as in circumstances where other beneficial owners have either a substantial business or substantial financial relationship with the insured. Letter of Michael L. Van Cise to Michael Desmond, William Paul, and Drita Tonuzi of IRS (May 9, 2019). Also, a comment letter submitted by Steven Gorin requested that relief extend to circumstances where the transfer is to a trust established to benefit charities. Letter of Steven B. Gorin to IRS (May 9, 2019).
- 68 Prop. Reg. section 1.101-1(d)(2)(i). The application of the substantial business relationship exception to the RPS definition is illustrated by Prop. Reg. section 1.101-1(g)(7) and (8), Examples 7 and 8.
- 69 Prop. Reg. section 1.101-1(d)(2)(ii).
- 70 Prop. Reg. section 1.101-1(d)(3)(i).
- 71 Prop. Reg. section 1.101-1(d)(3)(ii). A comment letter submitted on behalf of MB Schoen & Associates requested clarification that a substantial financial relationship exists for certain pooling arrangements through partnerships of bank-owned life insurance used to fund employee benefit obligations. Letter of Bryan W. Keene and Craig R. Springfield to IRS (May 8, 2019).
- 72 Prop. Reg. section 1.101-1(d)(3)(iii). A comment letter submitted by Steven Gorin requested relief for circumstances where a transfer of a contract to a charity is in part charitable and in part for value. Letter of Steven B. Gorin to IRS (May 9, 2019).
- 73 Prop. Reg. section 1.101-1(d)(4)(i). An indirect acquirer's substantial business or financial relationship is illustrated by Prop. Reg. section 1.101-1(g)(11), Example 11.
- 74 Prop. Reg. section 1.101-1(d)(4)(ii).
- 75 *Id.* See also Prop. Reg. section 1.101-1(g)(9), Example 9, regarding a transfer of a life insurance contract by a shareholder to a corporation. The exclusion from income under section 101 for the death benefit payable to the corporation was limited by the transfer-for-value rule. The example concludes that no substantial business or financial relationship exists on this fact pattern.
- 76 *Id.*
- 77 Prop. Reg. section 1.101-1(b)(1)(ii)(A).
- 78 *Id.* The amount that would have been excludable by the transferor had the transfer not occurred seemingly should be determined by assuming that the transferor continues to hold his or her interest in the contract (e.g., 100 percent ownership) through the date of the insured's death. See Prop. Reg. section 1.101-1(g)(8), Example 8.
- 79 *Id.*
- 80 Prop. Reg. section 1.101-1(b)(1)(ii)(B)(1).
- 81 Prop. Reg. section 1.101-1(b)(1)(ii)(B)(2). See also Prop. Reg. section 1.101-1(g)(5), Example 5.
- 82 A comment letter submitted by Steven Gorin requested that the example be revised to describe the transfer as being for value, and not necessarily for fair market value. Letter of Steven B. Gorin to IRS (May 9, 2019). This letter also requested that the regulations permit a "clean start" where there has been no prior RPS of the contract if the insured pays fair market value for the policy.
- 83 Prop. Reg. section 1.101-1(g)(5), Example 5; Prop. Reg. section 1.101-1(b)(1)(ii)(B)(2). The ACLI comment letter requested that insurers be permitted to check "taxable amount not determined" on Form 1099-R in certain situations where multiple transfers have occurred, such as when an RPS is followed by another transfer that is not an RPS. The ACLI comment letter references this Example 5 and also Example 6, discussed next, as examples of situations where such reporting is appropriate.
- 84 Prop. Reg. section 1.101-1(b)(2)(i). See also Prop. Reg. section 1.101-1(g)(2) and (6), Examples 2 and 6. If a contract has never been transferred for value, no limitation on the excludable death benefit should apply by reason of section 101(a)(2) or (3). Also, as noted earlier, the amount that would have been excludable by the transferor had the transfer not occurred seemingly should be determined by assuming that the transferor continues to hold his or her interest in the contract through the date of the insured's death. Thus, for example, if the transferor held 100 percent of the contract before the transfer and was not subject to any limitation on the excludable death benefit, then 100 percent of the death benefit would be excludable to the transferee who received the contract gratuitously from that transferor. Since the limitation on the transferee's exclusion is due to a carryover of a tax attribute from the transferor, seemingly a similar carryover of the attribute of any substantial family, financial, or business relationship that the transferor had with the insured should apply.
- 85 Prop. Reg. section 1.101-1(b)(2)(iii).
- 86 Prop. Reg. section 1.101-1(g)(6), Example 6; Prop. Reg. section 1.101-1(b)(2)(i).
- 87 ACLI comment letter, referencing the statutory language of section 101(a)(2) and (3).
- 88 84 FR 11009, 11015 (March 25, 2019).
- 89 T.D. 6280, 22 FR 10103, 10104 (Dec. 17, 1957). This sentence was included in the notice of proposed rulemaking published in the Federal Register at 20 FR 7484 (Oct. 7, 1955).
- 90 The legislative history of section 7702, in addressing contracts that under state law are treated as a combination of life insurance and an annuity, indicates that only the portion of the contract that is life insurance under state law is treated as a life insurance contract under section 7702. See, e.g., S. Prt. No. 98-169, vol. I, at 572 (1984).
- 91 The ACLI comment letter requested that the sentence in the regulations be retained.
- 92 84 FR 11009, 11019 (March 25, 2019).
- 93 Prop. Reg. section 1.101-6(b).
- 94 *Id.*
- 95 Letter from Marc Cadin, AALU, to Secretary Steven Mnuchin of Treasury and Commissioner Charles Rettig of the IRS (May 9, 2019).