

August 16, 2011

IRS Issues Interim Guidance on the Federal Income Tax Treatment of Annuity and Life Insurance Contracts with a Long-Term Care Insurance Feature

On August 11, 2011, the Internal Revenue Service (the IRS) released interim guidance – [Notice 2011-68](#) (the Notice) – addressing the application of certain changes to the federal income tax rules governing qualified long-term care (QLTC) insurance, annuity, and life insurance contracts. Specifically, the Notice provides interim guidance on the federal income tax treatment of annuity and life insurance contracts with a long-term care insurance feature, *i.e.*, combination products. Guidance on this topic has been pending on the annual priority guidance plan prepared by the Treasury Department and the IRS since 2009. The Notice also requests comments on several important issues to be addressed in future guidance concerning combination products.

Background

The Pension Protection Act of 2006 (the PPA) amended sections 72, 1035, and 7702B of the Internal Revenue Code of 1986 in regards to the federal income tax treatment of combination products and added certain new reporting requirements for charges and payments for QLTC insurance under combination products. In general, these amendments affect QLTC insurance, annuity, and life insurance contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009, and tax-free exchanges occurring after December 31, 2009. The information reporting amendment applies to charges made after December 31, 2009.

Amendments to Section 72. QLTC insurance coverage can be provided in conjunction with an annuity contract (or a life insurance contract) either as a separate insurance coverage paid for with direct premium payments or by drawing amounts from the cash value of the annuity contract (or, alternatively, the cash surrender value of the life insurance contract). The PPA added section 72(e)(11), which provides that a charge is not includable in income if it is made against the cash value of an annuity contract or the cash surrender value of a life insurance contract and constitutes payment for coverage under a QLTC insurance contract that is a part of, or is a rider to, the annuity or life insurance contract. The investment in the contract is reduced (but not below zero) by the charge. The PPA did not otherwise amend the definition provided in section 72(c)(1) and section 72(e)(6) for the term “investment in the contract.”

Amendments to Section 1035. The PPA expanded the categories of exchanges that are afforded nonrecognition treatment under section 1035 to include some exchanges that involve a QLTC insurance contract. For example, section 1035 now applies to the exchange of (i) a QLTC insurance contract for another QLTC insurance contract; (ii) an annuity contract for another annuity or QLTC insurance contract; (iii) a life insurance contract for another life insurance, endowment, annuity, or QLTC insurance contract; or (iv) an endowment contract for another endowment, annuity, or QLTC insurance contract. The PPA also amended section 1035(b)(2) and (3) to provide that, for purposes of section 1035, a contract does

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not fail to be treated as a life insurance contract or an annuity contract solely because a QLTC insurance contract is a part of, or is a rider to, such contract.

Amendments to Section 7702B; Information Reporting; DAC. In brief, the PPA also—

- Amended section 7702B(e) to provide that, in the case of any long-term care insurance coverage (whether or not qualified) provided as a part of, or as a rider to, a life insurance contract or an annuity contract, the portion of the contract providing such coverage is treated as a separate contract. Prior to this amendment, section 7702B(e) provided a similar rule, but only for long-term care insurance coverage provided as a part of a life insurance contract;
- Added section 6050U, which requires any person that makes a charge against the cash value of an annuity contract (or the cash surrender value of a life insurance contract) that is excluded from gross income under section 72(e)(11) to file an information return setting forth the aggregate amount of such charges for the year, the amount of the reduction in investment in the contract by reason of such charges, and the name, address, and TIN of the holder of the contract; and
- Added section 848(e), which treats an annuity or life insurance contract that includes a QLTC insurance contract as a part of, or as a rider to, such a contract as a contract that is subject to a capitalization rate for specified policy acquisition expenses (DAC) equal to 7.7% of net premiums.

The Notice – Application of the Amendments Made by the PPA

Amendments to Section 72. The Notice provides that all premiums paid for an annuity that also provides long-term care insurance generally are included in the investment in the contract under section 72 if (i) the premiums are credited to the contract's cash value (rather than directly to the long-term care insurance contract that is part of, or is a rider to, the contract) and (ii) coverage under the long-term insurance contract is paid for by charges against the cash value of the contract. Correspondingly, the Notice provides that a waiver of premiums under such a contract, such as on account of disability or because the annuitant has become chronically ill, should be accounted for in the same manner as a waiver of premiums under other contracts for which investment in the contract is determined under section 72(c)(1) or section 72(e)(6). See, e.g., *Estate of Wong Wing Non v. Commissioner*, 18 T.C. 205 (1952) (waived premiums not treated as constructively received as disability benefits, and therefore not included as part of premium paid for endowment life insurance policy).

Notably, the Notice does not provide guidance on how tax-free benefits received under the QLTC insurance portion of a combination product affect the investment in the contract of the annuity portion of that product. In Priv. Ltr. Rul. 200919011 (Feb. 2, 2009), the IRS concluded that such benefit payments will reduce the investment in the contract, but did not elaborate on how. The conclusion in that private letter ruling has been widely criticized, prompting the life insurance industry to request further guidance – in particular, that such benefit payments have no effect on the investment in the contract. Interestingly, the Notice does not identify this issue in the list of issues on which it seeks public comment.

Amendments to Section 1035. The Notice provides that, under section 1031(d), the adjusted basis of a QLTC insurance contract received in a tax-free exchange under section 1035(a) generally carries over from the life insurance, endowment, annuity, or QLTC insurance contract exchanged. Citing Rev. Proc. 2011-38, 2011-30 I.R.B. 66, which provided modified guidance with respect to the federal income tax treatment of “partial exchanges” of annuity contracts under sections 72 and 1035, the Notice also confirms that the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a QLTC insurance contract may be treated as a tax-free exchange, provided that the

requirements of section 1035 otherwise are met. (Our Legal Alert concerning Rev. Proc. 2011-38 can be accessed using the following [link](#).)

Amendments to Section 7702B; Information Reporting; DAC. The Notice offers a summary of the changes made by the PPA with respect to these topics.

Request for Comments

The Notice requests public comment on several questions “to assist in the development of further guidance” concerning the taxation of combination products. For example, the Notice provides as follows:

For the purpose of determining whether the long-term care features of an annuity contract *qualify as an insurance contract and thus as a qualified long-term care insurance contract*, what is the appropriate characterization of long-term care payments that cause a reduction in a contract's cash value? Are there common features or contract designs that would lend themselves to guidance on determining *whether enough insurance risk is present for the long-term care features to qualify as an insurance contract*? [Notice 2011-68, § 4.01(b) (emphasis added).]

In respect of this excerpt from the Notice, it is worthwhile to note that the IRS has recently issued several private letter rulings that address this risk shifting issue. See, e.g., Priv. Ltr. Rul. 201105001 (Oct. 22, 2010); Priv. Ltr. Rul. 200919011 (Feb. 2, 2009). Per these private letter rulings, the IRS has indicated that some unspecified portion must reasonably be expected to be paid from the issuing insurer's general account in order for the long-term care insurance features of an annuity contract to qualify as an insurance contract and, thus, as a QLTC insurance contract.

The Notice also identifies the following issues for public comment:

- What issues arise when the owner of an annuity contract with a long-term care insurance feature decides to annuitize the contract?
 - Are the policyholder's rights under the long-term care insurance feature typically the same or different before and after the annuity starting date?
 - How should long-term care insurance charges be accounted for after the annuity starting date?
 - How should the exclusion ratio be determined?
- Is guidance needed on the partial exchange of the right to some or all of the payments under an immediate annuity contract for a QLTC insurance contract?
 - If so, how is such an exchange effected?
 - Under what circumstances should such an exchange be treated as tax-free under section 1035?
 - How should the basis and investment in the contract be apportioned between the QLTC insurance contract received in the exchange and the rights still held in the annuity with respect to which the partial exchange is effected?

- What changes, if any, are needed to existing guidance (including publications, forms, and instructions) on information reporting and record keeping to assist issuers of life insurance, annuity, or QLTC insurance contracts in meeting their obligations with regard to the amendments made by the PPA?

Comments are due to be submitted to the IRS no later than November 9, 2011.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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