LEGAL ALERT

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FY 2011 Budget Contains a Number of Tax Proposals Targeting Insurance Companies

On February 1, 2010, the Administration released its fiscal year 2011 budget (FY 2011 Budget). Of note, the FY 2011 Budget includes a number of tax proposals that target insurance companies or that otherwise would have a direct effect on them. Those proposals include:

- Modifying the dividends-received deduction for life insurance company separate accounts. This proposal is a carryover from the fiscal year 2010 budget and is estimated to raise $1.808 billion over 5 years and $4.306 billion over 10 years.
- Disallowing the deduction for "excess non-taxed reinsurance premiums paid to affiliates." This proposal is new and is estimated to raise $233 million over 5 years and $519 million over 10 years.
- Permitting the partial annuitization of "nonqualified annuity contracts." This proposal is new and is estimated to raise $205 million over 5 years and $1.020 billion over 10 years.
- Extending the Subpart F "active financing" and "look-through" exceptions through December 31, 2011.
- Modifying the rules that apply to sales of life insurance contracts. This proposal is a carryover from the fiscal year 2010 budget and is estimated to raise $395 million over 5 years and $1.303 billion over 10 years.
- Imposing a "financial crisis responsibility fee" on "financial institutions." This proposal is estimated to raise $43 billion over 5 years and $90 billion over 10 years. The Administration first proposed this fee on January 14, 2010.
- Requiring information reporting for "private separate accounts" of life insurance companies. This proposal is a carryover from the fiscal year 2010 budget and is estimated to raise $14 million over 5 years and $58 million over 10 years.

We discuss these proposals and provide a brief overview of several other relevant proposals contained in the FY 2011 Budget below.

Modifying the Dividends-Received Deduction for Life Insurance Company Separate Accounts

In the case of a life insurance company, the dividends-received deduction (DRD) is permitted only with regard to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The regime for computing the company's share and policyholders' share of net investment income generally is referred to as proration.

A life insurance company's separate account assets, liabilities, and income are segregated from those of the company's general account in order to support variable life insurance and variable annuity contracts. A company's share and policyholders' share are computed for the company's general account and separately for each separate account.

The policyholders' share equals 100 percent less the company's share, whereas the latter is equal to the company's share of net investment income divided by net investment income. The company's share of net investment income is the excess, if any, of net investment income over certain amounts, including "required interest," that is set aside to satisfy obligations to policyholders. Required interest with regard to an account is calculated by multiplying a specified account earnings rate by the mean of the reserves with regard to the account for the taxable year.

According to the General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (FY 2011 Green Book), required interest under this proposal would equal an earnings rate times the mean of reserves. For a separate account, the earnings rate would equal a gross earnings rate (net investment income of the account, divided by the mean of the account's assets), minus a company-retained percentage (amounts retained by the company from the account's net investment income, if any, divided by the mean of reserves). For this purpose, amounts retained by the company would be treated as funded proportionately by items included in net investment income and items not so included. Under this proposal, the company's share with regard to a separate account would approximate the ratio of the mean of the surplus attributable to the account to the mean of the account's assets. The company's share with regard to a company's general account would be computed as under current law.

This proposal would be effective for taxable years beginning after December 31, 2010.

Disallowing the Deduction for "Excess Non-taxed Reinsurance Premiums Paid to Affiliates"

According to the FY 2011 Green Book, under this proposal, a U.S. insurance company would be denied a deduction for certain reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates. Specifically, the U.S. insurance company would not be allowed a deduction to the extent that (i) the foreign reinsurers (or their parent companies) are not subject to U.S. federal income tax with respect to premiums received and (ii) the amount of reinsurance premiums (net of ceding commissions) paid to foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business. This proposal also provides that a foreign corporation that is paid a premium from an affiliate that otherwise would be denied a deduction under this provision may elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States.

Notably, by adopting a § 163(j)-like approach, this proposal takes a different path than that followed by the bill that was reintroduced by Congressman Richard Neal, Chairman of the Subcommittee on Select Revenue Measures, in the U.S. House of Representatives on July 30, 2009 (2009 Neal Bill). In particular, the 2009 Neal Bill would disallow a deduction to any company subject to the tax imposed by § 831 for any reinsurance premium paid, directly or indirectly, to an affiliated corporation (other than a controlled foreign corporation as defined under § 957) if, with respect to such affiliated corporation, such premium is neither Subpart F income (as defined under § 952) nor subject to U.S. federal income tax. As a further point of distinction in comparison to the 2009 Neal Bill, this proposal appears to be applicable to life insurance companies as well as non-life insurance companies. The proposal leaves open the question of whether reinsurance premiums paid to companies subject to an applicable income tax treaty would fall within its purview.

This proposal would be effective for taxable years beginning after December 31, 2010.

Permitting the Partial Annuitization of "Nonqualified Annuity Contracts"

Under this proposal, partial annuitizations, *i.e.*, the application of part but not all of a contract's cash value to an annuity payment stream, generally would be eligible for "exclusion ratio" treatment, provided the annuity payment stream is for life (including multiple lives) or a period certain of at least 10 years. Under exclusion ratio treatment, which is set forth in § 72(b), part of each annuity payment is treated as a non-taxable recovery of the owner's investment in the contract, and the other part is treated as ordinary income. This proposal represents the first time that Treasury has proposed explicitly to treat partial annuitizations as eligible for exclusion ratio treatment.

To the extent that partial annuitizations are not eligible for exclusion ratio treatment, they are taxable under the rules of § 72(e) applicable to distributions from nonqualified annuity contracts before the annuity starting date. Under these rules, the entire amount of each payment from a nonqualified annuity contract is treated as gain taxable as ordinary income until all of the gain accumulated in the contract (generally, the excess of the contract's cash value over the owner's premium payments) has been taxed.

Current IRS guidance does not explicitly take the position that partial annuitizations are not eligible for exclusion ratio treatment under current law. In fact, the taxation of partial annuitizations has been identified for a number of years as an area where the IRS will not issue rulings because the area is under study, most recently in § 5.03 of Rev. Proc. 2010-3, 2010-1 I.R.B. 110 (Jan. 4. 2010). Informally, however, IRS staff has maintained that partial annuitizations are not eligible for exclusion ratio treatment because the annuity starting date – generally the date on which all of the obligations under an annuity contract become fixed – cannot occur until the entire cash value has been annuitized, and this view appears to be reflected in Rev. Proc. 2008-24, 2008-13 I.R.B. 684 (Mar. 13, 2008), relating to partial exchanges. Many companies have proceeded on the assumption that partial annuitizations are not eligible for exclusion ratio treatment in designing their products and their tax reporting systems. In short, this proposal, if enacted, would represent a major development in the taxation of nonqualified annuity contracts.

This proposal would be effective for partial annuitizations that are effected after December 31, 2010.

Extending the Subpart F "Active Financing" and "Look-Through" Exceptions

According to the FY 2011 Green Book, the Administration is proposing to extend the Subpart F "active financing" and "look-through" exceptions through December 31, 2011. These provisions applied to taxable years of foreign corporations beginning before January 1, 2010.

Modifying the Rules That Apply to Sales of Life Insurance Contracts

According to the FY 2011 Green Book, this proposal would require a person or entity that purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

This proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

This proposal would apply to sales or assignment of interests in life insurance policies and payments of death benefits for taxable years beginning after December 31, 2010.

Imposing a "Financial Crisis Responsibility Fee"

According to the discussion contained in the FY 2011 Budget, the Administration is calling for a fee that will last at least 10 years, "but longer if necessary." Furthermore, the fee would be limited to "financial firms with over $50 billion in assets," and "it would be based on an institution's size and exposure to debt."

According to the FY 2011 Green Book, the fee generally would be applied to banks, thrifts, bank and thrift holding companies, brokers, and securities dealers. U.S. companies owning or controlling these types of entities as of January 14, 2010, also would be subject to the fee. Firms with consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below this threshold.

As provided in the FY 2011 Green Book, the assessable base of the fee would include the worldwide consolidated liabilities of U.S. financial firms. Financial firms not based in the United States would be subject to the fee based on the liabilities of their U.S. subsidiaries. The fee base would include a broad set of liabilities with a few designated exceptions. For example, for insurance companies, certain policy-related liabilities would not be subject to the fee. In addition, "adjustments would be provided to prevent avoidance and to appropriately treat less risky activities, such as lending against certain high quality collateral."

The fee would be effective as of July 1, 2010, and the rate of the fee applied to covered liabilities would be "approximately 15 basis points." Accordingly, calendar year taxpayers would pay the fee with respect to two quarters of the year when filing their returns for 2010.

Requiring Information Reporting for "Private Separate Accounts" of Life Insurance Companies

According to the FY 2011 Green Book, this proposal would require life insurance companies to report to the IRS, for each contract whose cash value is partially or wholly invested in a private separate account for any portion of the taxable year and represents at least 10 percent of the value of the account, the policyholder's taxpayer identification number, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that was invested in one or more "private separate accounts." For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10 percent of the value of the separate account. Whether a related group of persons owns policies whose cash values represent at least 10 percent of the value of the account would be determined quarterly, based on information reasonably within the issuer's possession.

This proposal would be effective for taxable years beginning after December 31, 2010.

Additional Proposals of Note

In addition to the proposals discussed above, the FY 2011 Budget contains a number of proposals of more general interest. In particular, the FY 2011 Budget contains:

- A broad-ranging package of international tax proposals and includes (i) a scaled-back version of last year's proposal to limit deferral, (ii) a proposal requiring the determination of the foreign tax credit on a pooling basis, (iii) a proposal concerning the prevention of splitting foreign income from foreign taxes, (iv) a proposal limiting earnings stripping by expatriated entities, and (v) a proposal to modify tax rules for "dual capacity taxpayers." Significantly, Acting Assistant Treasury Secretary for Tax Policy Michael Mundaca has indicated that the proposal to limit deferral now will address only interest expenses, a significant change from last year's provision, which covered all expenses except those for research and development;
- A proposal to repeal the gain limitation for dividends received in all reorganization exchanges; and
- A proposal to codify the "economic substance doctrine."

In another significant change in the international area, the Administration decided to drop last year's proposal that would have restricted the use of the check-the-box entity classification regime for certain cross-border structures.

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

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