



WASHINGTON REPORT

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Subject: **Treasury Department Releases Explanation Of The Administration's 2010 Revenue Proposals Which Include Proposed Changes To The Taxation Of Life Insurance And Estates And Gifts**

Major References: [*General Explanations of the Administration Fiscal Year 2010 Revenue Proposals, Department of the Treasury \(May 2009\) \("Greenbook"\)*](#)

Prior AALU Washington Reports: 09-46; 09-43; 08-90; 07-64; 07-10; 06-11; 05-10; 03-78; 03-75; 03-74; 02-77; 01-16; 00-88; 00-17; 00-16

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The Treasury Department recently released its General Explanations of the Administration's Revenue Proposals for 2010, informally called the "Greenbook." In addition to changes to income tax rates, it (importantly for AALU) includes proposals to change a number of tax provisions in the Internal Revenue Code affecting life insurance and estates and gifts. Furthermore, the Administration has proposed a number of other new revenue raising items, including proposals for (i) changes in the tax rates for higher income individuals, (ii) mandatory IRAs and (iii) other provisions of special concern to AALU members.

A. Life Insurance Changes

Key life insurance provisions in the Administration's FY 2010 Revenue Proposals relate to (i) reporting requirements on the purchase of an existing life insurance contract with a death benefit of \$1 million or more, (ii) transfer for value rule changes that would limit the exceptions to that rule, (iii)

disallowance of otherwise deductible interest for businesses that own COLI policies, and (iv) additional disallowance of the dividends-received deduction relating to the life insurance industry.

1. Reporting for Sales of Existing Contracts. The proposal would require a person or entity, who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$1 million (i.e., a typical life settlement buyer), to report to the Revenue Service, to the insurance company that issued the policy, and to the seller (a) the purchase price, (b) the buyer's and seller's taxpayer identification numbers (TINs), and (c) the issuer and policy number. The concern is that, although recent years have witnessed growth in the number and size of life settlement transactions, compliance in reporting gain or loss from those transactions is sometimes hampered by a lack of information reporting. (For the Revenue Service's current position on the tax treatment of dispositions of life insurance policies in life settlement-type transactions, see generally Rev. Ruls. 2009-13 and 2009-14, discussed in our Bulletin No. 09-46.)

2. Transfer-For-Value Rules. Under the current "transfer-for-value" rule of Section 101 of the Code, the buyer of a previously-issued life insurance contract who subsequently receives a death benefit generally is subject to tax on the difference between the death benefit received and the sum of the amount paid for the contract and premiums subsequently paid by the buyer. This rule does not apply if the buyer's basis is determined in whole or in part by reference to the seller's basis, nor does the rule apply if the buyer is 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. The proposal 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 is similar (but not identical) to the reporting requirements proposed to be applicable to the policy buyer (see above).

The reporting requirements and the changes to the transfer-for-value rule 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.

3. Interest Expense Disallowance for COLI Policies. Interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts generally is not deductible, unless the insurance contract insures the life of a key person of the business (defined to include a 20-percent owner of the business, as well as a limited number of the business' officers or employees). This interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment or annuity contract.

In addition, to preemptively prevent Fannie Mae from engaging in a program which would have insured mortgage borrowers, in 1997 Congress enacted legislation providing that the interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values based on a statutory formula if the contracts do not cover individuals who are officers, directors, employees, or 20-percent owners of the taxpayer. In the case of both life and non-life insurance companies, special proration rules similarly require adjustments to prevent or limit the funding of tax-deductible reserve increases with tax preferred income, including earnings credited under life insurance, endowment and annuity contracts that would be subject to the pro rata interest disallowance rule if owned by a non-insurance company.

Citing concern that highly leveraged businesses can find ways to circumvent these rules, the proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers or directors, other than 20-percent owners of a business that is the owner or

beneficiary of the contracts. The proposal would be effective for contracts entered into after the date of enactment. A proposal of this nature has been considered by the Congress in the past and rejected on a bipartisan basis. AALU and the broader industry view the proposal as an indirect attack on the life insurance inside buildup and are taking strong actions to try to ensure that this proposal is again rejected.

4. *Modify Dividends-Received Deduction for Life Insurance Company Separate Accounts.*

Under current law, corporate taxpayers may generally qualify for a dividends-received deduction (DRD) with regard to dividends received from other domestic corporations, in order to prevent or limit taxable inclusion of the same income by more than one corporation. In the case of a life insurance company, the 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, including the separate accounts underlying its variable policies. 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 is sometimes referred to as “proration.”

The proration methodology currently used by some taxpayers may produce, in the Treasury's view, a company’s share that exceeds the company’s economic interest in the net investment income earned by its separate account assets. To address this alleged disparity, the Treasury proposes, effective for taxable years beginning after December 31, 2010, the retention of the current rule that required interest equals an earnings rate times the mean of reserves; however, 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.

Treasury asserts that it intends this formula to generally produce a company’s share with regard to a separate account that approximates the ratio of the mean of the surplus attributable to the account to the mean of the account’s assets.

The life insurance industry strongly opposes this proposal because it would increase taxes by undercutting longstanding rules that prevent double taxation of corporate earnings. All corporate taxpayers are entitled to a DRD. However, no other industry has been singled out for an additional DRD disallowance except the life insurance industry.

B. Estate and Gift Tax Changes

Although estate and gift tax provisions are assumed in the Greenbook to be extended to the calendar year 2010 at parameters currently in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of \$3.5 million), the proposal makes several changes to the current taxation of property transferred to family members in certain situations. Primarily it would (i) impose property basis consistency rules when the property is acquired from a decedent, (ii) broaden "applicable restrictions" categories that would cause a limitation on valuation discounts appropriate to closely held entities, and (iii) provide a new minimum 10-year term for GRATs. None of those proposed changes would be retroactive.

1. *Consistency In Value For Transfer And Income Tax Purposes.* The basis of property acquired from a decedent generally is the fair market value of the property on decedent’s date of death, and a donee’s basis in property received by gift during the life of the donor generally is the donor’s adjusted basis in the property, increased by gift tax paid on the transfer (or, if lower, its fair market value on the date

of the gift). While the recipient of a distribution of income from a trust or estate must report on the recipient's own income tax return the exact information included on the Schedule K-1 of the trust's or estate's income tax return, this provision applies only for income tax purposes, and the Schedule K-1 does not include basis information.

Effective as if the date of enactment, the proposal would require both consistency - for estate, gift and income tax purposes - and a reporting requirement. The basis of property received by reason of death would have to equal the value of that property for estate tax purposes. The basis of property received by gift during the life of the donor would have to equal the donor's basis determined as set forth above. This proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). In the absence of an applicable exception, a reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the IRS.

2. Modifications to Valuation Discounts. Section 2704(b) (enacted as part of Chapter 14 of the Internal Revenue Code) provides that, where a partnership or corporate interest is transferred to (or for the benefit of) a member of the transferor's family and, immediately before the transfer, the transferor and his family hold control of the entity, any "applicable restrictions" (including restrictions on the ability to liquidate the entity) are disregarded when valuing the transferred interest. Such restrictions are not disregarded, however, and will be given effect, if they are not more restrictive than state law provisions that would govern in the absence of provisions in the entity documents.

In *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002), *aff'g* 113 T.C. 449 (1999), *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001) and *Estate of Harper v. Commissioner*, T.C. Memo. 2000-202 (*see* our Bulletins Nos. 02-77, 00-16, 01-16 and 00-88), the Tax Court held that restrictions on the right of a limited partner to withdraw from, or liquidate his particular interest in, a limited partnership is not an "applicable restriction" on liquidation of the entity that must be disregarded for valuation purposes under section 2704(b). The IRS has long disagreed with these courts' positions based on its own interpretation of the Treasury regulations.

The proposal would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations. A disregarded restriction also would include any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met. The proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of section 2704).

3. *Minimum Terms for GRATs.* Section 2702 (also a part of Chapter 14) provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a “qualified interest” - *i.e.*, a fixed annuity or unitrust interest, as defined in applicable Treasury regulations. A grantor retained annuity trust - or GRAT - is one such qualified interest, and current law prescribes no particular minimum or maximum length of term for a GRAT.

GRATs, as noted in the proposal, have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, providing that the grantor survives the GRAT term and the trust assets do not depreciate in value. Taxpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor’s death during the term), in many cases to 2 years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

This proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years (a number that appears to have been chosen because it is the same as the 10-year minimum term of so-called “*Clifford*” trusts that were created on or before March 1, 1986). Although a minimum term would not prevent “zeroing-out” the gift tax value of the remainder interest, it would increase the risk of the grantor’s death during the GRAT term and the resulting loss of any anticipated transfer tax benefit. This loss would presumably be the Treasury’s gain.

This proposal would apply to trusts created after the date of enactment.

C. Miscellaneous Items of Special Relevance To AALU Members

1. *Tax Rates.* One of the cornerstones of President Obama’s campaign was to not raise tax rates on those earning less than \$250,000 per year. He made no such promise with respect to the rest of the population and his revenue proposals reflect that.

First, starting in 2011, he would restore the highest income tax rate back to 39.6%. This would be accomplished by simply letting the current law sunset (as it is scheduled to do) after 2010. Legislation is not necessary to accomplish this goal. The exact level at which the new 39.6% rate would apply will depend on cost-of-living adjustments but if it were applied in this year, it would apply to taxable income over \$372,950 (\$186,475 if married and filing separately).

Second, employing essentially the same strategy, the second highest rate would revert back to the 36% rate (the second highest rate before the enactment of EGTRRA) starting in 2011. The 36% rate would apply to income above \$250,000 (with certain adjustments) indexed from 2009 for married taxpayers filing jointly (\$200,000 for single filers) and an adjustment to the 28% tax bracket would be made so that there is no tax increase for those individuals.

Third, the Administration would restore the limitations on itemized deductions that applied before EGTRRA. In addition, starting in 2011, itemized deductions (other than medical expenses, investment interest, theft and casualty losses and gambling losses) would be reduced by 3% of the amount by which the taxpayer’s adjusted gross income exceeds certain statutory floors (but not by more than 80%). The floors would be inflation adjusted starting with the amount of \$250,000 in 2009 for married taxpayers filing jointly and \$200,000 in 2009 for single taxpayers.

Fourth, the Administration would restore the phase-out of personal exemption deductions starting in 2011 when the EGTRRA provision sunsets. Thus, for higher income individuals, the personal exemption deduction will be phased out starting with those whose adjusted gross income is \$250,000 in 2009 (adjusted for inflation to 2011) and \$200,000 (adjusted for inflation in 2009) for single taxpayers.

Fifth, the Administration's proposals would increase the capital gains rate from 15% to 20% on long-term capital gains for married taxpayers filing jointly with income over \$250,000 (with certain adjustments and indexed from 2009) and \$200,000 for single filers. It would also repeal the reduced capital gains rate on assets held over five years. For lower income individuals the current rule respecting 0% and 15% tax rates for capital gains and dividends would be retained.

2. Savers Credit. Current law provides for a Savers Credit for certain lower income individuals. The Savers Credit was designed to replicate the idea of an employer matching contribution in a retirement plan. Under current law, retirement contributions of up to \$4,000 (\$2,000 for single taxpayers) are eligible for a 10%, 20% or 50% Savers Credit, depending on the taxpayer's adjusted gross income.

The Administration finds the current rules are not sufficiently effective in encouraging moderate and lower income individuals to save for retirement and are overly complicated. For that reason, it would change the Savers Credit in a number of ways. First, it would make it fully refundable (currently it is not refundable and is only a credit against taxes due). Second, it would provide that the credit is deposited automatically in the qualified retirement plan or IRA in which the contribution was made. Third, it would replace the three-tiered matching rates with one matching rate of 50% of contributions up to \$500 per individual. Finally, it would expand those eligible for the credit to those making \$65,000 (married) and \$32,500 (single). The proposal would be effective December 31, 2010.

3. Automatic Enrollment in IRAs. It has been widely speculated that before the end of this session of Congress, automatic IRA enrollment will be enacted. That speculation was reinforced when Mark Iwry, the primary author and proponent of this idea, was hired to be Deputy Assistant Secretary of the Treasury.

Under this proposal, employers who are in business for at least two years and have 10 or more employees would be required to offer an automatic IRA option to employees on a payroll deduction basis. That is, if the employee so elected, contributions would be automatically taken from the payroll and deposited in an IRA. This requirement would not apply if the employer maintained a retirement plan or a SIMPLE plan for its employees. If an employer has a retirement plan that excludes certain employees, whether the employer has to offer the automatic IRA option to the excluded employees will depend on the nature of the exclusion. If the exclusion depends on whether the employees are subject to collective bargaining, are under 18, are nonresident aliens, or have not completed the plan's eligibility waiting period, they would not have to be offered the automatic IRA option. If they are excluded for any other reason, however, they would have to be offered this new automatic IRA option.

Employers who are offering automatic IRAs would give employees a standard notice and election form allowing them to either elect to participate or opt out. If the employee did not complete this form, i.e., does not opt in or out by election, then the employee would be enrolled at 3% of compensation.

The employer could elect to use a single IRA for this purpose or it could allow each participating employee to pick his or her own IRA provider.

Employers would not be responsible for investments in the IRA. A standard default investment and a “handful” of standard, low-cost investment alternatives would be prescribed by statute or regulation. There would not be any employer contribution or employer responsibility or liability in connection with these investments.

A two-year tax credit is available to employees making automatic payroll deposit IRAs in the amount of \$25 per employee up to a maximum of \$250 a year for each of the two years.

This proposal would be effective starting in 2012.

4. *Carried Interests for Service Partnerships.* An issue that has been heavily debated in Congress and in the press over the last few years is the taxation of so-called “carried interests.” This term applies to an interest a partner is entitled to receive in a partnership in return for future services. The taxation of these interests is commonly raised in connection with hedge funds, which are often structured as partnerships.

Under current law, there has been considerable debate about the proper method of taxing the interest. This has caused considerable uncertainty regarding the taxation of deferred compensation in connection with partnership income. For example, in the regulations under Code section 409A, the taxation of partnership deferred compensation was largely reserved because the IRS was not sure what basic rules should apply in this situation.

Under the Administration’s proposal, so-called “services of partnership interest” are subject to tax at ordinary income regardless of the character of the income and partnership level. In other words, the service partner would not be entitled to capital gain from income generated through the partnership and will be required to pay self-employment tax on that income as well.

5. *Economic Substance.* For years, a number of members of Congress have tried to enact legislation respecting the economic substance of transactions. This is mainly directed at tax shelters, but is likely to affect all kinds of business transactions. To some extent, the courts have developed their own limited economic substance doctrines which would appear to be overridden by enactment of the proposal that could, in some situations, apply to transactions which are not of the tax shelter variety.

Under the proposal, a transaction would satisfy the economic substance doctrine and thus be acceptable only if it (i) changes in a meaningful way (apart from tax issues) the taxpayer’s economic position and (ii) the taxpayer has a substantial purpose (other than taxes) for entering into the transaction. A transaction is not treated as having economic substance by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction.

Failure to comply with the economic substance doctrine would result in the denial of the tax benefit claimed as well as the imposition of a 30% penalty tax on the understatement of tax attributable to the transaction that lacks economic substance. The penalty is reduced to 20% if there is adequate disclosure on the tax return. Any deduction for interest attributable to an understatement of tax arising from the economic substance doctrine would be disallowed as well. This provision would apply on date of enactment.

6. ***Separate Account Information Reporting.*** Under this proposal, life insurance companies would be required to report to the Revenue Service various information about any investments in a “private separate account.” The information reported would require the identification of a policyholder and would provide information about the investment and the account value in the private separate account. A private separate account is any life insurance account with respect to which a related group of persons own policies whose cash values in the aggregate represent at least 10% of the value of the separate account. This proposal would be effective starting in 2011.

The purpose of this is to provide information to the IRS so they can locate and presumably challenge the tax treatment of the separate account. Presumably the IRS would argue that a taxpayer has too much control over the separate account and is therefore treated as the owner of the underlying investments. See our Bulletins Nos. 09-43; 08-90; 07-64; 07-10; 06-11; 05-10; 03-78; 03-75; 03-74; 00-17 for discussion of variable contract issues related to the issues underlying private separate account concerns.

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In many years the Administration's Budget proposals are not necessarily given much weight; Congress often ultimately ignores them. However, given the fact that the current Administration is Democratic and that party has a substantial control of Congress, it is conceivable that more aspects of this Budget may be enacted than is normally the case.

In contrast, it is still too soon to reasonably assume that any of the foregoing proposals will in fact be enacted in their current form (or at all). Furthermore, because none of the foregoing proposals is retroactive, planners may continue to utilize techniques which would be impacted by the proposals. We will continue to monitor the progress of the Administration's proposals as they move through the legislative process.

Any AALU member who wishes to obtain a copy of General Explanations of the Administration's Revenue Proposals may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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