Subchaper L: Can You Believe it?

Reserves for Annuity Contracts That Flunk I.R.C. § 72(s) Can Be Deductible

By Peter H. Winslow

In two of my *Taxing Times* columns last year, I dealt with the policyholder and company tax treatment of contracts that fail to qualify as life insurance contracts under I.R.C. § 7702.[1] In the October 2015 *Taxing Times* column, I pointed out that a life insurance company is entitled to a tax reserve deduction for a contract that flunks I.R.C. § 7702. After writing that piece, I have been asked: What about the tax treatment of contracts that do not qualify as annuity contracts for tax purposes because they lack the requisite distribution-after-death provisions of I.R.C. § 72(s)? As it turns out, the same result applies as for failed life insurance contracts—the life insurance company should obtain a tax reserve deduction for a contract that fails to qualify as an annuity contract under I.R.C. § 72(s) provided the contract has a lifetime annuity payout option.

Let's explore how this is the likely result. I.R.C. § 72(s) provides, with certain exceptions, that a contract is not treated as an annuity contract "for purposes of this title" unless it provides that annuity benefits will be distributed within five years of the holder's death or, if annuitization had commenced before death, at least as rapidly as under the method of distribution being used at the time of death. The phrase "for purposes of this title" refers to all provisions of the Internal Revenue Code, that is, Title 26 of the United States Code. This means that when determining the issuing company's tax treatment of a contract that flunks I.R.C. § 72(s) the contract cannot be considered an annuity contract. This broad application of I.R.C. § 72(s) has significant potential ramifications.

The company tax issues that need to be addressed when a contract fails to qualify as an annuity contract under I.R.C. § 72(s) are: (1) whether the premium is includible in income; (2) if so, the type of insurance reserve deduction that is applicable; and (3) whether the policy acquisition expenses (DAC) provisions apply. The DAC issue is the easiest to answer. Under I.R.C. § 848(c)(1), only specified insurance contracts are subject to the so-called "DAC tax" whereby expenses equal to a designated percentage of net premiums (1.75 percent in the case of annuity contracts) are required to be capitalized and amortized as a deduction ratably over a 120-month period. Specified insurance contracts are limited to life insurance, annuity and noncancellable (or guaranteed renewable) accident and health insurance contracts. Because a failed annuity is not an annuity contract for tax purposes by reason of I.R.C. § 72(s), it is not a specified insurance contract and the DAC tax does not apply. As a result, the recurring expenses incurred to sell the contracts are currently deductible. Regulations under I.R.C. § 162 provide that "advertising and other selling expenses" are currently deductible on an accrual basis as ordinary and necessary business expenses.[2]

Whether the premium for a failed annuity is includible in the issuer's gross income requires more analysis. The answer lies in determining whether the contract qualifies as an insurance contract. If it does, the consideration received from the contract holder would be includible when accrued as premium income.[3] Guidance in IRS rulings primarily relating to pre-1984 Act law and in analogous 1984 Act legislative history suggests that, to de-

termine whether a contract that provides for periodic payments is insurance, we first should examine whether a payout option is available that incorporates life contingencies, *i.e.*, a payment option for life is available. Next, for a failed deferred annuity we examine whether, during the deferral stage of the contract, purchase rates for the life-contingent payout options are guaranteed. If the contract provides only a term certain annuity option, or if there are no meaningful purchase rate guarantees, the contract likely is considered debt for tax purposes. In such case, the same tax treatment as a guaranteed investment contract would apply—no premium income and no reserve deduction. On the other hand, if a life annuity payment option is available for a failed deferred annuity and there are meaningful purchase rate guarantees, the contract likely would qualify as an insurance contract for tax purposes, albeit not an annuity or life insurance contract. As a result, premium income with a corresponding insurance reserve deduction would be the correct treatment for the company issuing the contract. This insurance contract characterization is supported by legislative history that concludes that a failed life contract and a deposit administration contract that is not an annuity because it lacks permanent purchase rate guarantees are nevertheless insurance contracts for which reserve deductions are available.[4]

As in the case of a failed life insurance contract, a contract's failure to satisfy the criteria for annuity contract treatment under I.R.C. § 72(s) means that the tax reserve computational rules in I.R.C. § 807(d) do not apply. By its terms, I.R.C. § 807(d) only applies to life insurance reserves which, like the DAC rules, are held only with respect to life insurance, annuity and noncancellable (or guaranteed renewable) accident and health insurance contracts.[5] Because I.R.C. § 72(s) provides that a contract cannot be an annuity contract for all purposes of the Internal Revenue Code if it fails to include the requisite distribution-after-death provisions, reserves held for the contract cannot be subject to the I.R.C. § 807(d) tax reserve computational rules. Again, analogous legislative history under the 1984 Act is helpful in determining the proper classification of the reserve. In the case of a deposit administration contract that is a failed annuity because it lacks permanent purchase rate guarantees, the legislative history says that a reserve deduction is available under I.R.C. § 807(c)(3) or (4).[6] In general, for a failed deferred annuity, the applicable classification would be an I.R.C. § 807(c)(4) reserve—"amounts held at interest in connection with insurance … contracts," assuming the deferred annuity has an identifiable account value to which interest is added. The amount of the tax reserves for this type of contract would be the full account value of the contract to which interest is added.

What happens if the contract annuitizes? The most likely tax treatment upon annuitization is that the tax character of the contract changes. After annuitization, in most cases where a life time annuity payout option is elected the contract would satisfy the distribution-after-death requirements of I.R.C. § 72(s) going forward. The fact that the contract previously did not qualify does not seem to matter. Unlike I.R.C. § 7702 for a life insurance contract, I.R.C. § 72(s) qualification does not require compliance "at any time," *i.e.*, including all prior contract years. Therefore, there is no reason why a previously failed contract would not qualify as an annuity once I.R.C. § 72(s) criteria are satisfied. If that is the case, then the tax treatment at annuitization probably would be similar to a deposit administration contract with temporary purchase rate guarantees upon annuitization. The insurance contract (*i.e.*, the failed annuity) would be considered surrendered. The I.R.C. § 807(c)(4) reserve would be released generating income that would be offset by a deduction for the deemed payment of the account value upon the surrender. The account value would then be applied as the purchase price of the now-I.R.C. § 72(s)-compliant annuity contract and included in premium income. The premium income would be subject to the DAC tax and a new reserve—now a life insurance reserve—would be computed subject to the tax reserve adjustments required by I.R.C. § 807(d).

It is unlikely that Congress gave much thought to the issuer's tax consequences for failed annuity contracts in enacting the 1984 Act. But, whether or not Congress intended the results outlined in this column, following the requirements of the Internal Revenue Code where they lead for failed annuity contracts does not seem to give an adverse answer for the issuing company, at least when the contract retains its character as insurance.

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ENDNOTES

1. Peter H. Winslow, "Subchapter L: Can You Believe It? Withholding and Reporting May Not be Required for Income on Failed Life Insurance Contracts," *Taxing Times* Vol. 11, issue 2, page 52 (June 2015); Peter H. Winslow, "Subchapter L: Can You Believe It? Deductible Tax Reserves Might be Greater for Life Insurance Contracts That Flunk I.R.C. § 7702 Than for Those That Do Not," *Taxing Times* Vol. 11, issue 3, page 46 (October 2015).
2. Treas. Reg. § 1.162-1(a).
3. I.R.C. § 803(a)(1).
4. H.R. Rep. No. 98-432, pt. 2, at 1413 n.128 (1984); Joint Comm. on Taxation, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 597 n.19 (1984).
5. I.R.C. § 807(c)(1), § 816(b).
6. H.R. Rep. No. 98-432, pt. 2, at 1403 n.125 (1984); Joint Comm. on Taxation, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 584 n.8 (1984).