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Internal Revenue Service
CC:PA:LPD:PR (Notice 2011-68)
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Committee of Annuity Insurers Comments on IRS Notice 2011-68

Dear Sir or Madam,

We are writing on behalf of the Committee of Annuity Insurers (the “Committee”) to respond to the request for comments in Notice 2011-68 (the “Notice”).¹ Among other things, the Notice requests comments on issues involving the taxation of annuity contracts with a long-term care (“LTC”) insurance feature (referred to herein as “annuity-LTC contracts”). This letter comments on the following:

- (1) The tax treatment of benefits paid under the qualified LTC insurance (“QLTCI”) portion of an annuity-LTC contract in cases where such benefits reduce the amounts payable under the annuity portion of the contract;
- (2) Various issues under section 1035 with respect to exchanges involving annuity contracts, QLTCI contracts, and annuity-LTC contracts, including issues relating to deferred annuities and payout annuities involved in such exchanges;²
- (3) Issues involving the commencement of annuity payments under the annuity portion of an annuity-LTC contract; and
- (4) Issues involving the “risk-shifting” attributes of the QLTCI portion of an annuity-LTC contract.

¹ 2011-36 I.R.B. 205. The Committee is a coalition of life insurance companies formed in 1982 to participate in the development of federal policy with respect to annuities. The Committee’s current 32 member companies represent more than 80% of the annuity business in the United States. A list of the Committee’s member companies is attached.

² Unless otherwise indicated, each reference herein to a “section” means a section of the Internal Revenue Code of 1986, as amended (the “Code”).

The Committee believes that published guidance on which all taxpayers may rely is needed and would be helpful on many of the issues discussed herein. In that regard, in addition to identifying and discussing issues on which we are requesting published guidance, this letter also responds to other issues identified in the Notice but on which we do not think there is a current pressing need for published guidance. The Committee appreciates the opportunity to provide these comments and looks forward to continuing a dialogue with the Internal Revenue Service (the “Service”) and the Treasury Department on these important issues.

I. Treatment of Benefits Paid Under Annuity-LTC Contracts

A. Tax-Free Nature of QLTCI Benefits

The Pension Protection Act of 2006 (“PPA”) amended section 7702B(e) to include special rules for annuity-LTC contracts.³ By their nature, such contracts involve certain interactions between the LTC and annuity benefits under the contract. For example, a QLTCI rider to a deferred annuity might provide for LTC insurance benefits that reduce the annuity’s cash value by some amount.⁴ Such LTC insurance benefits are excludable from gross income in the same manner as other QLTCI benefits, irrespective of their effect on the annuity’s cash value.

The statutory structure of section 7702B dictates the foregoing conclusion. Under section 7702B(e)(1), if an annuity contract provides (by rider or otherwise) for LTC insurance coverage, all provisions of the Code apply “as if the portion of the contract providing such coverage is a separate contract.” As a result of this “separate contract” rule, any benefits that are paid pursuant to the QLTCI portion of a contract (*i.e.*, as LTC insurance benefits upon the insured’s chronic illness) are treated as paid from a QLTCI contract, and not from an annuity contract, for all federal income tax purposes.⁵ Thus, QLTCI rider benefits are excludable to the same extent as those paid under a stand-alone QLTCI contract,⁶ irrespective of how they may affect the annuity portion of the contract.

³ Pub. L. No. 109-280 § 844 (2006).

⁴ In this regard, two basic designs have emerged in the marketplace for QLTCI riders to deferred annuities. Under a “tail design,” the QLTCI benefits payable under the rider have the effect of reducing the annuity’s cash value dollar-for-dollar throughout an initial phase, and thereafter are comprised entirely of amounts that do not affect the annuity benefits at all (called “net amount at risk” or “NAR”). *See* PLR 201105001 (Oct. 22, 2010). Under a “*pro rata*” or “coinsurance” design, each LTC benefit payment includes some NAR while also reducing the annuity’s cash value by less than the total QLTCI benefit. *See* PLR 200919011 (Feb. 2, 2009). Variations on these basic designs also exist.

⁵ Prior to the PPA amendments, the separate contract rule of section 7702B(e)(1) applied (1) with respect to life insurance contracts (but not annuities) combined with LTC insurance contracts, and (2) only for purposes of section 7702B, not for all purposes of the Code. The PPA amendments, *inter alia*, (1) expanded the separate contract rule to apply to annuity-LTC contracts, and (2) made it apply for all purposes of the Code (retroactive to the original 1996 effective date of section 7702B(e), in the case of life insurance contracts with LTC insurance features).

⁶ *See* section 7702B(a)(2) (amounts other than policyholder dividends and premium refunds received from a QLTCI contract are treated as amounts received for personal injuries and sickness); section 104(a)(3) (excluding such amounts from the taxpayer’s gross income). *See also* section 7702B(d)(2) (imposing limits on the excludability of *per diem* benefits under a QLTCI contract).

The legislative history of the PPA amendments confirms this interpretation of the statute. It expressly states that, in the case of an annuity contract with a QLTCI rider, “amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, *whether or not the payment of such amounts causes a reduction in the ... annuity contract’s cash value.*”⁷ Accordingly, Congress intended that QLTCI rider benefits be excluded from gross income in the same manner as QLTCI benefits paid under a stand-alone QLTCI contract, irrespective of how the rider benefits affect the annuity contract.

The Service also confirmed this conclusion in a 2009 private letter ruling (the “2009 PLR”).⁸ However, there is no published guidance on this point on which all taxpayers can rely. As a result, the Committee requests the Service and Treasury Department to confirm in published guidance that benefits paid under the QLTCI portion of an annuity-LTC contract will not fail to be excludable from gross income merely because those benefits also reduce the amounts otherwise payable under the annuity portion of the contract.

B. The Effect of LTC Insurance Benefits on Investment in the Contract

Because benefits paid under the QLTCI portion of an annuity-LTC contract are excludable from gross income in the same manner as other QLTCI benefits irrespective of their effect on the annuity portion of the contract, a question arises whether the payment of such excludable benefits affects the “investment in the contract” (or “IVC”) of the annuity portion. Although the PPA did not explicitly address this question, the Service concluded in the 2009 PLR that such rider benefits will reduce the IVC of the annuity portion of the contract.⁹

The Committee believes that the 2009 PLR’s conclusion on this point is erroneous. Moreover, the Committee is concerned that some taxpayers may feel compelled to follow the 2009 PLR’s view, while others may adopt a contrary view based on what they (and we) believe is a more appropriate interpretation of applicable law. In light of this possibility, and given the centrality of this issue to ensuring the proper tax reporting and treatment of payments from an annuity-LTC contract, the Committee urges the Service and the Treasury Department to publish guidance clarifying that, for the reasons discussed below, IVC is not reduced by any of the benefits paid under the QLTCI portion of an annuity-LTC contract.

⁷ STAFF OF THE J. COMM. ON TAX’N, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, THE “PENSION PROTECTION ACT OF 2006,” AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, at 195 (Comm. Print 2006) (hereinafter, the “JCT Explanation”) (emphasis added). A similar statement was included in the 1996 legislative history accompanying the original enactment of section 7702B(e). H.R. REP. NO. 104-736, at 298-99 (1996) (Conf. Rep.); H.R. REP. NO. 104-496, at 118 (1996). There were no official committee reports accompanying the PPA amendments, so Congress designated the JCT Explanation as the official legislative history. See 152 Cong. Rec. H6158 (daily ed. July 28, 2006) (statement of Ways and Means Committee Chairman William Thomas) (“[a] detailed, plain-English explanation [of the PPA] is available from the Joint Committee on Taxation and will be a key resource in understanding the intent underlying the bill’s provisions and, therefore, obviously of the legislative intent behind the bill.”); 152 Cong. Rec. S8763 (daily ed. Aug. 3, 2006) (statement of Senate Finance Committee Chairman Charles Grassley) (similar).

⁸ PLR 200919011 (Feb. 2, 2009).

⁹ See *id.* The 2009 PLR does not address the manner in which any such reduction to the IVC should be determined.

1. Reducing IVC would be inconsistent with the separate contract rule

Only certain excludable amounts that are received “under” or “with respect to” an annuity contract reduce its IVC.¹⁰ Benefits paid pursuant to the QLTCI portion of an annuity-LTC contract are not paid under the annuity portion, and therefore cannot reduce the owner’s IVC in the annuity portion.

In that regard, as discussed above, section 7702B(e)(1) provides that a QLTCI rider to an annuity contract is treated as a separate contract from the annuity contract for federal income tax purposes. In addition, the legislative history expressly states that benefits paid pursuant to that separate contract are treated as LTC insurance benefits, whether or not they cause a reduction in the annuity’s cash value.¹¹ This legislative history reflects the congressional intent that LTC insurance benefits paid pursuant to such a rider are excludable from gross income in the same manner as LTC insurance benefits paid under a stand-alone QLTCI contract. Under the Code, the only way that such rider benefits can be excludable from gross income as LTC insurance benefits is if they are treated as paid under or with respect to a QLTCI contract.

As a result, QLTCI rider benefits are not treated as paid under or with respect to an annuity contract, even if they reduce the cash value or other amounts payable under the annuity contract. Pursuant to section 7702B(e)(1), this “separate contract” treatment applies for all purposes of the Code, including for purposes of the definition of IVC in section 72(c)(1) and (e)(6). As indicated above, section 72(c)(1) and (e)(6), as well as the regulations thereunder, provide that only excludable amounts received “under” or “with respect to” an annuity contract will affect its IVC. Because QLTCI rider benefits are treated for all federal income tax purposes as received from a separate QLTCI contract, and not from an annuity contract, they cannot reduce the annuity contract’s IVC.

The Service reached a similar conclusion in a private letter ruling involving disability annuity payments that were excludable from gross income under section 104(a)(4).¹² That section generally excludes from gross income amounts received as a disability annuity under certain federal laws. The taxpayer requested a ruling that such disability annuity payments would not reduce his IVC as defined in section 72(c) for purposes of determining the taxability of annuity payments made to his surviving spouse. The Service noted that such disability annuity payments are excludable from gross income under section 104(a)(4) until the taxpayer

¹⁰ See section 72(e)(6) (defining IVC, in relevant part, as premiums paid minus “the aggregate amount received *under the contract* before such date, to the extent that such amount was excludable from gross income under [subtitle A of the Code] or prior income tax laws.”) (emphasis added). See also section 72(c)(1) (similar definition, but with a provision regarding refund features that is not relevant here); Treas. Reg. section 1.72-6(a)(1) (similar definition, but describing amounts that reduce IVC as the sum of “(i) The total amount of any return of premiums or dividends received ... and (ii) The total of any other amounts received *with respect to the contract* ... which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.”) (emphasis added). The regulations go on to state that amounts to which item (ii) applies include, for example, “amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code.”

¹¹ See *supra* note 7 and accompanying text.

¹² PLR 7730064 (Apr. 29, 1977).

dies, but that payments made to his surviving spouse would be taxable under section 72. The Service then concluded that:

amounts paid to [the taxpayer] which are excludable from his gross income under section 104(a)(4) in Chapter 1 of the Code, are not amounts paid under a contract to which section 72 of the Code applies. Accordingly, such payments do not reduce the investment in the contract, for purposes of section 72(b) of the Code ..., or the consideration paid for the contract by the employee, for purposes of section 72(d)...

2. Reducing IVC would be inconsistent with section 72(e)(11)

Reducing IVC by QLTCI rider benefits also would be inconsistent with the reduction in the IVC required by section 72(e)(11) in the case of QLTCI rider charges assessed against the cash value of an annuity contract. Under that section, such rider charges are treated as distributions from the annuity contract, which are then used to purchase a separate contract, *i.e.*, the QLTCI rider.¹³ It would be fundamentally inconsistent to (1) treat such rider charges as distributions “under” the annuity contract that are paid into a separate contract, and (2) also treat the benefits received from that separate contract as amounts received “under” the annuity contract. Stated differently, the statutory structure does not support treating QLTCI rider charges as distributions from the annuity while simultaneously treating the QLTCI rider benefits resulting from the coverage purchased by those rider charges as constituting amounts received from the annuity contract.

3. Reducing IVC would be inconsistent with the regulations under section 72

Reducing IVC by QLTCI rider benefits also would be inconsistent with Treas. Reg. section 1.72-2(b)(1)(i). That provision states that section 72 generally applies to amounts received under an annuity contract, but “if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Internal Revenue Code, section 72 shall not apply for the purposes of including such amounts in gross income.”¹⁴ If the IVC of the annuity portion of an annuity-LTC contract were reduced by LTC insurance benefits paid under the QLTCI portion of the contract, then, as the examples in the next part of this discussion demonstrate, in a variety of circumstances section 72 would cause such LTC insurance benefits

¹³ While section 72(e)(11)(B) provides that charges for a QLTCI rider are not includible in gross income, section 72(e)(11)(A) reflects their treatment as distributions from the annuity contract by reducing IVC by the amount of such charges. If such charges were not distributions from the annuity contract, there would be no need for section 72(e)(11)(B) to exclude them from gross income because the charges would be internal to the annuity contract and, like other internal charges, would operate to reduce the *income* on the contract rather than the IVC. In addition, paragraphs (2) and (3) of section 7702B(e), prior to the PPA amendments, reflect the treatment of charges for QLTCI riders as distributions from the base contracts (life insurance in the context of those provisions).

¹⁴ The regulation cites section 104(a)(4) (the section involved in PLR 7730064, discussed above) as an example of a Code provision that provides an exclusion from gross income for amounts otherwise taxable under section 72. *See also* Treas. Reg. section 1.72-15(f), Example 2 (describing the tax treatment of amounts governed by former Code section 105(d) (providing a limited income tax exclusion for certain sick pay benefits) and stating that “[t]he excludable portion of payments does not reduce B’s investment in the contract or the amount of premiums considered to have been paid by B for purposes of any subsequent computations under section 72.”).

to be includible in gross income. In other words, section 72 would “apply for the purposes of including such amounts in gross income,” even though sections 7702B and 104(a)(3) are intended to exclude them from gross income.

4. Reducing IVC would thwart congressional intent

Reducing the IVC of the annuity portion of an annuity-LTC contract upon the payment of benefits under the QLTCI rider would be inconsistent with the intent of Congress to exclude such benefits from income even in cases where the benefits reduce the amounts payable under the annuity. If QLTCI rider benefits were viewed as reducing the annuity’s IVC, a deferral of tax, rather than the intended exclusion from income, could be a common consequence. This is because any reduction in the IVC will increase the amount of income that is recognized in connection with subsequent transactions involving the annuity contract (*e.g.*, a final distribution at death).

For example, assume that a QLTCI rider to a deferred annuity provides for LTC insurance benefits equal to \$20,000 per year. Assume further that the product follows a “tail design,” under which the annual LTC insurance benefits reduce the annuity’s cash value dollar-for-dollar until the cash value is exhausted, then continue for a specified period as LTC insurance benefits comprised entirely of NAR. Finally, assume that the IVC for the deferred annuity is \$40,000 and the income on the contract (or gain) is \$60,000.

If the insured dies after receiving two tax-free annual rider benefit payments of \$20,000 each, and his IVC for the annuity contract is reduced by the full amount of such rider benefits, his beneficiary will inherit a deferred annuity with a \$60,000 built-in gain. In this scenario, sections 7702B and 104(a)(3) provide no income tax exclusion whatsoever; the same \$60,000 built-in gain that existed in the annuity when the insured became chronically ill remains in the contract at his death. In other words, due to the reduction in the IVC in this example, sections 7702B and 104(a)(3) would simply reverse the “income-first” ordering rule of section 72(e), and would not permanently exclude any amount from gross income.

Now assume that the insured instead receives three tax-free annual rider benefit payments of \$20,000 before he dies. His IVC in the annuity is reduced from \$40,000 to \$0 by the first two annual rider benefits as described above, and the gain in the annuity is reduced from \$60,000 to \$40,000 by the next annual rider benefit. The results are the same as in the example above, except that in this scenario sections 7702B and 104(a)(3) provide a permanent exclusion for the \$20,000 of gain in the annuity that the QLTCI rider extinguished. By surviving for an additional year while chronically ill, the insured receives a permanent income tax exclusion, rather than only the income tax deferral that he received in the prior example.

In these examples involving a common annuity-LTC contract design, the effect of reducing IVC under section 72 by excludable QLTCI rider benefits is that the availability of an income tax exclusion is contingent on the insured surviving long enough with his chronic illness to fully exhaust his IVC. The longer he lives, the bigger the tax benefit he receives. On the other hand, if he does not live long enough, the IVC adjustment under section 72 could eliminate the section 7702B / 104(a)(3) exclusion in its entirety. These types of results, where QLTCI rider benefits provide no income tax exclusion or one that is contingent on surviving long durations with chronic illness, are inconsistent with the intent of section 7702B and the PPA

amendments thereto. As indicated above, Congress enacted those amendments so that the amounts otherwise available under an annuity contract may be used to provide insurance benefits under a QLTCI rider that are treated like stand-alone QLTCI benefits. This cannot occur if IVC is reduced by the excludable QLTCI rider benefits.

5. Conclusion

Based on the foregoing, the Committee respectfully requests that the Service and Treasury Department publish guidance confirming that the IVC of the annuity portion of an annuity-LTC contract is not reduced by any benefits paid under the QLTCI portion of the contract.

II. Section 1035 Exchange Issues

The PPA amendments to section 1035 facilitate tax-free exchanges of an annuity contract for a QLTCI contract or an annuity-LTC contract. Several issues can arise in the context of such exchanges. The Notice identifies some of these issues, but not others. The Committee requests that the Service and Treasury Department publish guidance on the issues discussed below.

A. Partial Exchanges of Deferred Annuities

1. Clarify that Rev. Proc. 2011-38 does not apply to certain exchanges

Section 3.05 of the Notice confirms that a partial exchange of a deferred annuity for a QLTCI contract is entitled to nonrecognition treatment under section 1035, assuming that the requirements of section 1035 otherwise are met. This is very helpful guidance because, as discussed below, in practice partial exchanges are often the only effective means of engaging in an exchange of an annuity for a QLTCI contract.¹⁵ However, clarification is needed regarding the potential application of Rev. Proc. 2011-38¹⁶ to partial exchanges involving QLTCI contracts or annuity-LTC contracts.

In that regard, Rev. Proc. 2011-38 provides guidance on the treatment of a partial exchange of a deferred annuity for another deferred annuity. On its face, it does not (and should not) apply to partial exchanges of an annuity contract for a QLTCI contract. Rev. Proc. 2011-38 could be interpreted, however, as applying to the partial exchange of (1) a deferred annuity or a deferred annuity-LTC contract for (2) an annuity-LTC contract. The Committee would have serious concerns if such an interpretation were adopted.

The Committee's concerns relate to section 4.02 of Rev. Proc. 2011-38, which provides that withdrawals taken from an annuity contract involved in a partial exchange of annuity contracts within the previous 180 days could trigger elevated scrutiny by the Service in order to determine whether the partial exchange was entered into as a tax-avoidance device. The Service's stated concern with such transactions is that taxpayers may attempt to use them to avoid the rules under section 72(e) or (q) that normally apply to withdrawals from a deferred

¹⁵ See page 11 *et seq.*

¹⁶ 2011-30 I.R.B. 66.

annuity by structuring the withdrawal as a two-step transaction involving a partial exchange followed by a withdrawal.¹⁷

Whatever basis might exist to the Service's concerns regarding the tax avoidance potential for annuity-to-annuity partial exchanges, the likelihood that tax avoidance would motivate a person to enter into a partial exchange involving an annuity-LTC contract is virtually nil. A taxpayer enters into a partial exchange involving an annuity-LTC contract to obtain LTC insurance coverage. The purchase of such a contract involves additional costs relating to the LTC insurance coverage that are not present under a stand-alone deferred annuity. In addition, in some cases, taking a withdrawal from a deferred annuity with a QLTCI rider could reduce the LTC insurance coverage under the product. As a result of these considerations, if a taxpayer was seeking to circumvent section 72(e) or (q) through a partial exchange, it is highly unlikely that an annuity-LTC contract would be involved.

Unless it is clarified that Rev. Proc. 2011-38 does not apply to partial exchanges involving annuity-LTC contracts, taxpayers may be hesitant to engage in such exchanges out of concern that routine transactions involving such contracts could trigger an elevated level of scrutiny from the Service. For example, assume that an individual was taking systematic withdrawals from his deferred annuity to provide retirement income, and he then decided to exchange a portion of the contract for an annuity-LTC contract in order to obtain LTC insurance protection. If the taxpayer continued taking withdrawals from the deferred annuity during the ensuing 180 days and Rev. Proc. 2011-38 applied, the withdrawals might trigger an elevated level of scrutiny by the Service.

Many life insurers presumably would disclose to their policyholders the potential for such transactions triggering elevated scrutiny from the Service, advising them to consult their own tax advisers before entering into what otherwise would be a routine transaction lacking any hint of tax avoidance. While the likelihood of a tax-avoidance motivation existing in such a transaction is low, failure to exclude the transaction from Rev. Proc. 2011-38's scope will, to some degree, inevitably discourage its use. Given this possibility and the lack of any significant abuse potential, partial exchanges involving annuity-LTC contracts should be excluded from Rev. Proc. 2011-38. Of course, the Service would still be able to apply general tax principles to any transaction in order to determine whether it should be respected for tax purposes, so excluding annuity-LTC contracts from the scope of Rev. Proc. 2011-38 would not prevent the Service from combating abuse where it exists.

In addition to the treatment of exchanges involving annuity-LTC contracts, the Committee is concerned about the potential applicability of Rev. Proc. 2011-38 to partial exchanges of an annuity for a stand-alone QLTCI contract. Although, on its face, Rev. Proc. 2011-38 does not apply to such transactions, the Notice cites to the revenue procedure when discussing them. If Rev. Proc. 2011-38 (or similar guidance) were to apply in such circumstances, it could trigger elevated scrutiny for routine transactions that do not involve any

¹⁷ See, e.g., Rev. Rul. 2003-76, 2003-2 C.B. 355 (expressing concern that "some taxpayers may enter into a partial exchange of a portion of one annuity contract for a new annuity contract as a means of reducing or avoiding tax that would otherwise be imposed under § 72(e)."); AOD 1999-16, 1999-2 C.B. xvi (acquiescing in *Conway v. Comm'r*, 111 T.C. 350 (1998), but expressing concern with partial exchanges that are "part of a design to avoid application of the section 72(q) ten percent penalty, or any other limitation imposed by section 72.").

abuse potential. This is because, as discussed below (see page 10 *et seq.*), stand-alone QLTCI contracts typically call for modal (*e.g.*, monthly) premiums. As a result, funding the coverage under such a contract through an exchange of an annuity will often require the use of a series of partial exchanges of the annuity. This, in turn, means that the annuity may always be within a 180-day window described in Rev. Proc. 2011-38 (*e.g.*, each monthly partial exchange starts a new 180-day period), so that any withdrawal or other cash distribution from the annuity (*e.g.*, to provide retirement income) at any time after the first partial exchange for the QLTCI contract could trigger elevated scrutiny if Rev. Proc. 2011-38 were to apply.

Based on the foregoing, the Committee respectfully requests that the Service and Treasury Department publish guidance to clarify that Rev. Proc. 2011-38 does not apply to partial exchanges involving an annuity-LTC contract or a stand-alone QLTCI contract.

2. Clarify basis and IVC issues in partial exchanges of deferred annuities

Section 3.06 of the Notice confirms that the adjusted basis, under section 1031(d), of a QLTCI contract received in a tax-free section 1035 exchange of an annuity, endowment, or life insurance contract generally carries over from the contract being exchanged. The Committee appreciates this helpful guidance. An additional clarification is needed, however, with regard to partial exchanges of deferred annuities for QLTCI contracts.

In particular, it is not clear from the Notice how the carryover basis rule applies to partial exchanges. The Committee assumes that the IVC and adjusted basis would be apportioned between the deferred annuity and QLTCI contract, respectively, *pro rata* based on the cash value transferred to the QLTCI contract and the deferred annuity's cash value prior to the transfer. This is the same treatment that Rev. Rul. 2003-76 applies to partial exchanges involving deferred annuities.¹⁸ The Committee respectfully requests that the Service and Treasury Department publish guidance confirming these conclusions regarding partial exchanges of deferred annuities for QLTCI contracts.¹⁹

B. General Requirements for Tax-Free Exchanges of Annuities for QLTCI Contracts

The regulations under section 1035 elaborate on the requirements that must be met in order for an exchange to receive nonrecognition treatment under that section. The regulations were promulgated in 1956,²⁰ and they have not been updated since then – including in response to the PPA's expansion of section 1035 to cover certain exchanges involving QLTCI contracts. As a result, questions can arise regarding what requirements apply to such exchanges. For example, it is not clear how, if at all, the requirement in the regulations that exchanges “relate to the same insured” applies in an exchange of an annuity for a QLTCI contract.²¹

¹⁸ Of course, there is no IVC for a QLTCI contract or rider because section 72 does not apply to them. Rather, only the concept of adjusted basis applies. *See also* section 7702B(b)(2)(C).

¹⁹ *See* page 18, *infra*, for comments on similar issues involving partial exchanges of payout annuities for QLTCI contracts.

²⁰ T.D. 6211, 1956-2 C.B. 29, at 98.

²¹ *See* Treas. Reg. section 1.1035-1 (flush language).

In light of the PPA's amendments to section 1035, the Committee requests that the Service and Treasury Department issue a notice of proposed rulemaking ("NPRM") to update the regulations to reflect these amendments. The NPRM process would give all interested parties an opportunity to provide input on appropriate changes to the regulations. The Committee would expect to file separate comments in connection with any such NPRM and would be happy to assist in any other way that the Service and Treasury Department might find helpful.

C. Exchanges of Payout Annuities for QLTCI Contracts

Section 4.01(c) of the Notice asks several questions about the need for guidance on the partial exchange of the right to some or all of the payments under an immediate annuity contract for a QLTCI contract. In particular, it asks (1) how is such an exchange effected, (2) under what circumstances should it be treated as tax-free under section 1035, and (3) how should the basis and IVC be apportioned between the QLTCI contract received in the exchange and the rights retained in the annuity after the exchange? The discussion immediately below explains the need for published guidance on the topic of partial exchanges of payout annuities for QLTCI contracts and then discusses each of the Notice's questions on this topic.²²

1. The need for published guidance

It is relatively rare for a stand-alone QLTCI contract to allow the payment of a single premium that funds coverage for the insured's entire life.²³ Rather, in most cases, QLTCI contracts require modal premiums (*e.g.*, annual or monthly) that continue until the insured dies or becomes chronically ill. As a result of this ongoing premium requirement, an exchange of an annuity contract to fund QLTCI coverage generally must be structured as a series of exchanges (*e.g.*, annual or monthly) that correlate with the premium obligations under the QLTCI contract. In addition, because the modal premium obligation under a QLTCI contract generally continues until the insured dies or becomes chronically ill, in many cases the use of a life-contingent, payout annuity provides the best (and perhaps perfect) correlation with the QLTCI premium obligations, allowing the owner to pay a single premium for the annuity contract that ensures appropriate funding for the LTC insurance coverage for the whole of life.

It may not be feasible, however, for an individual to engage in a one-time exchange of an entire life-contingent payout annuity for a QLTCI contract. For example, the purchaser likely would want to include a refund feature (such as a period certain or guaranteed minimum payout) in the life-contingent annuity, so that premature death will not cause an economic loss for his beneficiaries. In such case, the annuity owner would not want to transfer the refund feature to the QLTCI issuer as part of the exchange, and the QLTCI issuer would have no interest in obtaining rights to the post-death payments because the premium obligations under the QLTCI contract will cease upon death. Likewise, such premium obligations would cease if the owner

²² Our use of the term "payout annuity," rather than "immediate annuity," includes immediate annuities (within the meaning of section 72(u)(4)) as well as deferred annuities under which annuity payments have commenced.

²³ This generally is because the incidence of chronic illness can be less predictable than other insurable events. As a result, insurance companies want to retain the flexibility to adjust premiums, prospectively and on a class basis, if the predicted morbidity rates differ from those actually experienced. A single premium product would not allow insurers to do this.

decides to cancel the QLTCI coverage and could cease if the insured under the QLTCI contract becomes chronically ill. For these reasons, an exchange of a payout annuity for a QLTCI contract generally must occur *via* a series of partial exchanges. Indeed, such partial exchanges of payout annuities for QLTCI contracts are occurring in the marketplace today, with insurers and their policyholders treating them as nonrecognition events under section 1035.

2. How a partial exchange of a payout annuity for a QLTCI contract is effected

In practice, a partial exchange of a payout annuity for a QLTCI contract could be effected in a number of ways. However, such transactions could be structured along the following lines:

- The owner would execute an agreement that identifies the transaction as an exchange of part of his or her interest in a payout annuity for a QLTCI contract.
- The agreement would assign to the QLTCI contract issuer the right under the annuity contract to receive part or all of one or more future annuity payments thereunder.
 - This could be done by the owner executing a new assignment with respect to a portion of the annuity contract prior to each annuity payment becoming due. This approach is impractical, however, because it requires repeated, ongoing action by the policyholder, whereas one of the goals of partially exchanging a payout annuity for a QLTCI contract is to establish an “automatic” funding mechanism for the LTC insurance coverage.
 - In light of the foregoing, it is more common for the parties to execute a single or “evergreen” assignment to effectuate a partial exchange of a payout annuity for a QLTCI contract. Such an assignment would schedule a series of partial exchanges of some or all of the contract rights to annuity payments that will later become payable under the contract. Each such partial exchange would be scheduled to occur prior to the due date for the relevant annuity payment(s).
 - Each future partial exchange may be conditioned on certain events not occurring prior to the scheduled exchange date, including events that extinguish the future premium obligations under the QLTCI contract, such as the insured’s death or chronic illness or the cancellation of the QLTCI coverage for any reason. The specified contingencies also could include the owner’s cancellation of the future scheduled partial exchanges.
 - Absent the occurrence of one of the specified contingencies prior to the scheduled exchange date, the exchange would occur.
- Based on the assignment, the issuer of the payout annuity would remit the relevant annuity payments directly to the issuer of the QLTCI contract as those payments become due.

3. Tax-free treatment under section 1035

The Notice acknowledges that an exchange of an entire deferred annuity contract or part of a deferred annuity contract for a QLTCI contract can qualify for nonrecognition treatment under section 1035. Likewise, it seems indisputable that the exchange of an entire payout annuity for a QLTCI contract can qualify for such treatment, considering that section 1035 does not distinguish between payout and deferred annuities in stating that nonrecognition treatment applies to the exchange of “an annuity contract for a qualified long-term care insurance contract.”²⁴ As a result, the only remaining question is whether section 1035 applies to a *partial* exchange of a payout annuity for a QLTCI contract. We see no reason why it should not.

The legislative history of section 1035 states that nonrecognition treatment is intended to apply to “individuals who have merely exchanged one insurance policy for another better suited to their needs.”²⁵ This is precisely what occurs when a payout annuity is partially exchanged for a QLTCI contract – a taxpayer has an interest in one insurance policy (the payout annuity) and exchanges it for an interest in another insurance policy better suited to his or her needs (a QLTCI contract). As the Tax Court concluded in *Conway v. Commissioner*,²⁶ it does not matter under section 1035 that the owner retains some rights in the contract being exchanged; nonrecognition treatment applies nonetheless.

Moreover, the PPA amendments to section 1035 were intended to permit individuals to fund their QLTCI coverage in a tax-efficient manner by using annuity contracts to provide the funding for the coverage without triggering current taxation. For the reasons discussed above, a series of partial exchanges of a life-contingent payout annuity often provides the best match to the modal premium structure of a QLTCI contract. In light of this structural “fit” and the congressional intent underlying section 1035 (as originally enacted and as modified by the PPA), the partial exchange of a payout annuity for a QLTCI contract should qualify for nonrecognition treatment under section 1035.

We appreciate that a partial exchange of a payout annuity may appear to invoke issues that are not as clearly presented in the partial exchange of a deferred annuity because, in the former case, annuity payments have already commenced when the exchange occurs. For example, a question may arise as to whether the owner can exchange one or more annuity payments before they become due without being treated as having constructively received them. Similarly, a question may arise as to whether the owner’s assignment of one or more annuity payments is merely an assignment of the right to receive future income to which the “assignment of income doctrine” applies, rather than an exchange of property to which section 1035 applies. As discussed below, however, these questions can be readily answered and do not preclude the application of section 1035 to the partial exchange of a payout annuity for a QLTCI contract.

²⁴ Indeed, the regulations under section 72, which were promulgated in the same Treasury Decision as the regulations under section 1035 (T.D. 6211, 1956-2 C.B. 29), are replete with references to payout annuities. Thus, there would seem to be no question that an exchange of a payout annuity for a QLTCI contract involves “like kind” property for purposes of the nonrecognition treatment provided by section 1035.

²⁵ H.R. REP. NO. 83-1337, at 81 (1954); S. REP. NO. 83-1622, at 110 (1954).

²⁶ 111 T.C. 350 (1998), *acq.*, 1992-2 C.B. xvi.

a. Constructive receipt doctrine

Prior to the actual receipt of an annuity payment under a payout annuity, the contract owner has not recognized any gain with respect to his or her contractual right to receive the payment. This is because the owner's right to receive future annuity payments is not fully mature, *i.e.*, the owner has no right to a present payment. This is consistent with the "constructive receipt" doctrine,²⁷ as well as section 72(b), which taxes annuity payments only as they are actually received. Thus, as long as the owner exchanges his or her contractual right to receive an annuity payment for an interest in a QLTCI contract before the payment becomes due, the exchange will occur before the owner is required to recognize any gain. Likewise, section 1035 defers the recognition of gain on the actual exchange itself.

b. Assignment of income doctrine

Because a payout annuity involves rights to receive periodic payments in the future, it is conceivable that an owner's assignment of some (or all) of those rights to another person in return for property might be perceived as a mere assignment of the owner's right to receive future income, rather than an exchange of property-for-property to which section 1035 applies.²⁸ In some cases, courts have applied the "assignment of income" doctrine to conclude that the transferor cannot escape tax on the income he or she is entitled to receive in the future, or change the tax character of that income, merely by assigning the right to receive it to another person.

This doctrine, however, has no applicability in the context of an assignment that is made to effectuate a section 1035 exchange. As explained below, this is because (1) the tax policy concerns at which the assignment of income doctrine are directed are not present in a partial exchange of a payout annuity for a QLTCI contract, and (2) even if the doctrine were found to have some potential applicability to such a partial exchange, the statutory nonrecognition rule of section 1035 would override its application.

(1) *The tax policy concerns at which the assignment of income doctrine are directed are absent*

All annuity contracts can be viewed as financial instruments that give rise to future payments consisting in part of income. Prior to the annuity starting date, the contract represents the right to future income in the form of interest or earnings that will be credited to the contract's cash value. After the annuity starting date, the contract represents the right to future income in the form of annuity payments that exceed the portion of such payments allocable to IVC. In light of these income-producing features, the assignment of income doctrine certainly can apply to an

²⁷ See Treas. Reg. section 1.446-1(c)(1)(i); Treas. Reg. section 1.451-2(a). *Compare* Blum v. Higgins, 150 F.2d 471 (2nd Cir. 1945) (taxpayer was in constructive receipt of the maturity proceeds left with the insurance company because such proceeds were available to him without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment would be made).

²⁸ While section 1035(a) does not refer to "property," it is an exception to the general rule in section 1001 that gain or loss is recognized upon the "sale or other disposition of property." See also, *e.g.*, section 1035(c) and (d) (referring to "property"); Rev. Rul. 90-109, 1990-2 C.B. 191 (treating a deemed exchange of a life insurance contract as taxable under section 1001 where the exchange did not qualify for nonrecognition treatment under section 1035).

assignment involving an annuity contract. For example, in Rev. Rul. 69-102,²⁹ a taxpayer who owned an annuity contract and gratuitously transferred the contract to his son was taxable under assignment of income principles on the surrender proceeds that the son later received under the contract. Absent this application of the assignment of income doctrine, the taxpayer could have shifted the incidence of tax on the annuity proceeds from himself to his son.

In that regard, the courts developed the assignment of income doctrine specifically to prevent this type of result. For example, in *Lucas v. Earl*,³⁰ the Supreme Court held that salary income was taxable to the person who earned it, and that “no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.”³¹ Likewise, in *Commissioner v. P.G. Lake, Inc.*,³² the Supreme Court held that interest in an oil well or sulfur mine that would have produced ordinary income was not a capital asset when the taxpayers sold the interest. Rather, the Court viewed the sale proceeds as a mere substitution for what otherwise would have been ordinary income, and held that this tax character cannot be avoided by assigning the interests in a sale or exchange.

In contrast, a taxpayer who exchanges an interest in a payout annuity for a QLTCI contract is not attempting to shift the incidence of tax on the future income payments by transferring them to another person. Rather, the taxpayer is attempting to transfer values from one piece of property that he owns (the payout annuity) to another piece of like-kind property that he also owns (the QLTCI contract). Likewise, the taxpayer is not attempting to change ordinary income to capital gain.³³ In the absence of such effects on the incidence of tax or character of income, the assignment of income doctrine simply does not apply.

Moreover, pursuant to the adjusted basis rules of section 1031(b), the individual taxpayer presumably would remain taxable at ordinary income rates on any income transferred to the QLTCI contract if that contract is subsequently cancelled and the owner receives a cash payment upon such cancellation that exceeds his or her adjusted basis.³⁴ Likewise, the individual would remain taxable on any benefits paid under the QLTCI contract that are not excludable from gross income, such as benefits in excess of the *per diem* limits of section 7702B(d)(2). In other words, the individual remains potentially taxable at ordinary income tax rates on both the annuity and the QLTCI contract after the partial exchange. This further demonstrates that neither the

²⁹ 1969-1 C.B. 32.

³⁰ 281 U.S. 111 (1930).

³¹ *Id.* at 115.

³² 356 U.S. 260 (1958).

³³ Of course, in any exchange of an annuity for a QLTCI contract, there is a possibility that the owner effectively will alter the tax treatment of gain in the annuity from ordinary income that is taxable under section 72 to tax-free benefits that are excludable under section 104(a)(3). This potential result, however, is inherent in the congressional decision to provide nonrecognition treatment for such exchanges. If Congress intended only to allow annuities with no tax-deferred inside buildup to be exchanged for QLTCI contracts, then the PPA amendments to section 1035 would not have been necessary because such exchanges would not trigger any taxable income.

³⁴ See section 3.06 of Notice 2011-68 (regarding carryover basis in an exchange of an annuity for a QLTCI contract); *cf.* section 7702B(b)(2)(C) (stating that “any refund on a complete surrender or cancellation of the contract shall be includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums”).

incidence of taxation nor the character of income is altered in a partial exchange of a payout annuity for a QLTCI contract, and that the assignment of income doctrine is therefore inapplicable to such a transaction.

- (2) *Even if the assignment of income doctrine were found to have some potential applicability, section 1035 would override its application*

It is clear that section 1035 applies to the assignment of an annuity contract in the context of an exchange described in section 1035. For example, section 1035 applies to a full or partial exchange of a deferred annuity for another deferred annuity.³⁵ This demonstrates that, even though a deferred annuity can be viewed as a right to future income to which the assignment of income doctrine may apply (as in Rev. Rul. 69-102), an assignment of the contractual rights to some or all of that income in exchange for property that section 1035 deems to be “like kind” is nonetheless a nonrecognition event under section 1035. Likewise, section 1035 should apply to the assignment of rights to receive some or all of the amounts under a payout annuity in exchange for rights in another insurance policy that section 1035 deems to be like-kind property.

In this sense, the nonrecognition rule in section 1035 overrides the potential application of the assignment of income doctrine (or similar doctrine) that otherwise might apply to the assignment of rights under an annuity in exchange for property. Any other view would mean that the assignment of income doctrine conceivably could apply to every exchange of an annuity to which section 1035 is intended to apply, thereby thwarting the congressional intent to provide nonrecognition treatment for “individuals who have merely exchanged one insurance policy for another better suited to their needs.”³⁶ Courts have adopted a similar view when considering the interaction between the assignment of income doctrine and Code sections that provide nonrecognition treatment for transactions that otherwise would implicate that doctrine.

For example, in *Hempt Brothers, Inc. v. United States*,³⁷ the Third Circuit Court of Appeals declined to apply the assignment of income doctrine to a transfer that implicated a nonrecognition rule under section 351 of the 1954 Code because doing so would have frustrated the intent of Congress in enacting that nonrecognition rule.³⁸ The transaction was a partnership’s assignment to a successor corporation of certain accounts receivable representing the right to receive future income payments. The court framed the issue as illustrating “the conflict between the statutory purpose of Section 351, postponement of recognition of gain or loss, and the assignment of income doctrine....”³⁹ The court first concluded that the assignment of the future

³⁵ See, e.g., Rev. Rul. 2002-75, 2002-2 C.B. 812 (exchange of deferred annuity into existing deferred annuity tax-free under section 1035); *Conway v. Comm’r*, 111 T.C. 350 (1998), *acq.*, 1992-2 C.B. xvi (exchange of a portion of an annuity contract for a new annuity contract qualified for nonrecognition treatment under section 1035); Rev. Rul. 2003-76, 2003-2 C.B. 355 (same); Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (same); Notice 2011-68 (same, but involving the exchange of part of an annuity contract for a QLTCI contract).

³⁶ See *supra* note 25.

³⁷ 490 F.2d 1172 (3d Cir. 1974), *cert. denied* 419 U.S. 826.

³⁸ Section 351 of the 1954 Code generally provided nonrecognition treatment for the transfer of property to a corporation solely in exchange for stock in that corporation if the transferor controlled the corporation immediately after the transfer. Current Code section 351 provides a similar rule.

³⁹ 490 F.2d at 1173.

income payments was an assignment of “property” to which section 351 could apply.⁴⁰ It then held that, despite the potential application of the assignment of income doctrine, “the totality of circumstances here presented fit the mold of the Congressional intent to give nonrecognition treatment” to the transaction.⁴¹

Similarly, in *Balding v. Commissioner*,⁴² the Tax Court concluded that marital rights to a military pension were treated as property under section 1041 and therefore the transfer of such rights incident to a divorce qualified for nonrecognition treatment under that section.⁴³ The Commissioner argued that the taxpayer’s relinquishment of certain rights to the future pension payments in return for three annual settlement payments was an anticipatory assignment of income, such that the settlement payments she received were immediately taxable to her under the assignment of income doctrine. The Tax Court declined to apply the assignment of income doctrine, even though it normally would apply to the transaction in question, and instead concluded that “whether we view petitioner’s release as constituting (or equivalent to) a transfer of property, or simply a release of marital rights, the transaction whereby she received the settlement payments requires that we analyze her receipt in light of section 1041.”⁴⁴ Accordingly, the statutory nonrecognition rule trumped the assignment of income doctrine.

The Service also has reached this conclusion. In Rev. Rul. 2002-22,⁴⁵ the Service concluded that the nonrecognition provision in section 1041 applied to the assignment of a right to receive future income (specifically, deferred compensation rights) even though the assignment of income doctrine otherwise would apply to the transaction. The Service stated that “the courts and the Service have long recognized that the assignment of income doctrine does not apply to every transfer of future income rights,” and that “applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041....”⁴⁶ The Service also observed that section 1041 applies to transfers of “property,” and while section 1041 does not define that term, there was no indication that Congress intended it to have a restricted meaning under section 1041, and “[t]o the contrary, Congress indicated that § 1041 should apply broadly to transfers of many types of property, including those that involve a right to receive

⁴⁰ *Id.* at 1175 (“[u]nless there is some special reason intrinsic to ... [Section 351] ... the general word ‘property’ has a broad reach in tax law.”) (quoting *E.I. Du Pont de Nemours and Co. v. U.S.*, 471 F.2d 1211, 1218-19 (Ct. Cl. 1973)). The court further observed that the meaning of the term property “must be viewed in the context of Section 351 application,” and that the right to receive future income *via* accounts receivable was “a normal, rather than an exceptional accoutrement of the type of business included by Congress in the transfer to a corporate form.” *Id.*

⁴¹ *Id.* at 1178. The court also observed that “[e]ven though Section 351(a) immunizes the transferor from immediate tax consequences, Section 358 retains for the transferors a potential income tax liability to be realized and recognized upon a subsequent sale or exchange of the stock certificates received.” *Id.*

⁴² 98 T.C. 368 (1992).

⁴³ Section 1041(a) provides that “[n]o gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce.”

⁴⁴ *Id.* at 373.

⁴⁵ 2002-1 C.B. 849.

⁴⁶ *Id.* at 850.

ordinary income that has accrued in an economic sense (such as interests in trusts and annuities).”⁴⁷

Based on these authorities, the assignment of income doctrine has no application to a taxpayer’s assignment of some or all of the rights to receive amounts under a payout annuity in return for rights in a QLTCI contract. The fact that a payout annuity (or a deferred annuity, for that matter) involves a right to receive future income does not mean that the assignment of such right falls short of being a transfer of “property” to which the nonrecognition rule of section 1035 applies. The term “property,” to the extent relevant in applying section 1035 to an exchange involving an annuity, must be interpreted in the context of that section,⁴⁸ and the context dictates that annuity contracts by their very nature provide for the right to receive future income. In other words, the right to future income is a “normal, rather than an exceptional accoutrement”⁴⁹ of an annuity, so section 1035 necessarily contemplates that the transfer of such a right is inherent in any exchange involving an annuity contract.

If the transfer of a right to future income as part of an exchange of an annuity for other property described in section 1035 were treated as an anticipatory assignment of income, then section 1035 might not apply to any such exchange. Of course, this would clearly frustrate the purpose of section 1035, which Congress intended to apply broadly to provide nonrecognition treatment for “individuals who have merely exchanged one insurance policy for another better suited to their needs.”⁵⁰ As the discussion above indicates, the Service and courts have not applied the assignment of income doctrine to transactions to which a specific nonrecognition provision of the Code also applies if doing so would frustrate the congressional intent underlying the nonrecognition provision.

In that regard, for the reasons discussed above, in many cases a life-contingent payout annuity provides the best match to the modal premium structure of a QLTCI contract. In light of this structural “fit,” the clear congressional intent to facilitate annuities as a tax-deferred funding mechanism for QLTCI coverage, the lack of any distinction between payout and deferred annuities in section 1035, and the fact that the Service and courts have concluded that a tax-free exchange of an annuity does not require the exchange of all the rights under the annuity,⁵¹ the partial exchange of a payout annuity for a QLTCI contract should qualify for nonrecognition treatment under section 1035. The Committee requests that the Service and Treasury Department publish guidance confirming this conclusion.

⁴⁷ *Id.*

⁴⁸ *Hempt Brothers*, *supra* note 41.

⁴⁹ *Id.*

⁵⁰ *See supra* note 25.

⁵¹ *See Conway v. Comm’r*, 111 T.C. 350 (1998), *acq.*, 1992-2 C.B. xvi (exchange of a portion of an annuity contract for a new annuity contract qualified for nonrecognition treatment under section 1035); Rev. Rul. 2003-76, 2003-2 C.B. 355 (same).

4. Basis and IVC allocation

The Notice asks for comments on how IVC and basis should be apportioned in a partial exchange of a payout annuity for a QLTCI contract. As the Notice recognizes, sections 1035(d)(2) and 1031(d) generally provide that the adjusted basis of property received in a section 1035 exchange is the same as the adjusted basis of the property exchanged.⁵² In Rul. 2003-76, the Service applied the foregoing provisions in the context of a partial exchange of a deferred annuity for another deferred annuity, concluding that the owner's adjusted basis and IVC in the old contract was allocated ratably between the contracts based on the percentage of cash value retained and transferred in the exchange.⁵³ This same *pro rata* concept should apply in a partial exchange of a payout annuity for a QLTCI contract.

In the context of a payout annuity, the exclusion ratio for the contract can be used to determine the *pro rata* allocation of basis and IVC when the contract is partially exchanged for a QLTCI contract. In that regard, the exclusion ratio generally is determined by dividing the IVC by the expected return based on the scheduled annuity payments.⁵⁴ As a result of this calculation, each annuity payment includes a *pro rata* amount of the owner's IVC. To the extent that the owner exchanges the right to receive an annuity payment for an interest in a QLTCI contract, the rights exchanged would carry with them the portion of IVC determined using the exclusion ratio.⁵⁵ Thus, the unrecovered IVC for the payout annuity would be reduced by the IVC reflected in the annuity payment being exchanged, as would be the case even in the absence of a partial exchange. The Committee requests that the Service and Treasury Department publish guidance confirming these conclusions.

III. General Questions Involving Annuitized Contracts

Section 4.01(a) of the Notice asks several questions involving the commencement of annuity payments under the annuity portion of an annuity-LTC contract. In particular, the Notice asks (1) what issues arise when the owner of an annuity-LTC contract decides to annuitize the contract, (2) are the policyholder's rights under the LTC insurance feature typically the same or different before and after the annuity starting date, (3) how should LTC insurance charges be accounted for after the annuity starting date, and (4) how should the exclusion ratio be determined? The issues that arise upon annuitization of an annuity-LTC contract are primarily the three latter categories of questions listed above. Thus, our response (below) focuses on those questions.

⁵² Section 3.06 of the Notice.

⁵³ The ruling cites Treas. Reg. sections 1.1031(j)-1(c), 1.1031(j)-1(d) ex. 5, and 1.61-6(a) as supporting the adoption of a *pro rata* rule for allocating basis and IVC in a partial exchange.

⁵⁴ See section 72(b)(1); Treas. Reg. section 1.72-4. See also H.R. REP. NO. 83-1337, at 10 (1954) (describing section 72(b) as a provision that "spreads the tax-free portion of the annuity income evenly over the annuitant's lifetime."); S. REP. NO. 83-1622, at 11 (1954) (same).

⁵⁵ We note that the exclusion ratio calculation would include a downward adjustment to the IVC if the payout annuity is life-contingent and contains a refund feature. See Treas. Reg. section 1.72-7. As described above, a partial exchange of a payout annuity for a QLTCI contract would not transfer any rights with respect to such a refund feature. Thus, an exclusion ratio calculation reflecting a refund feature remains an appropriate measure of the IVC that is transferred in connection with such a partial exchange.

As an initial matter, however, we observe that the Notice's questions on annuitization seem to assume that the underlying annuity contract is a deferred annuity that the owner annuitizes at some point. This is not an unreasonable assumption, given that most annuity-LTC contracts available in the marketplace today combine deferred annuities with LTC insurance coverage. As a result, the discussion below focuses primarily on such annuity-LTC contracts. However, contract designs that combine immediate annuities with LTC insurance coverage have been contemplated and could be developed in the future.⁵⁶

A. Policyholder's Rights Upon Annuitization of an Annuity-LTC contract

A variety of annuity-LTC contract designs have emerged in the marketplace since the PPA amendments became effective, and more are likely to evolve in the future. As a result, it is difficult to generalize about the effect of annuitization on the policyholder's rights under an annuity-LTC contract. However, based on the actual and potential contract designs of which the Committee is generally aware, we offer the following observations.

- *Mandatory annuitization under deferred annuity.* Deferred annuities generally specify a maturity date by which annuity payments must commence. In general, such mandatory annuitization provisions under a deferred annuity-LTC contract could affect the LTC insurance coverage as follows:
 - The maturity date could be postponed if the insured is chronically ill and LTC insurance benefits are being paid when the maturity date otherwise would occur. This facilitates the continued payment of the same LTC insurance benefits that are being paid under the rider during the insured's chronic illness.
 - If the insured is not chronically ill when the maturity date occurs, then annuity payments could commence as scheduled. In such case, the policyholder's rights could be affected as follows, depending on the particular contract design:
 - The LTC insurance coverage could continue, with the remaining benefits structured to completely replace the annuity payments being made if and when the insured becomes chronically ill. Alternatively, they could be structured to be paid in addition to any annuity payments otherwise payable. In either case, the effect would be that chronic illness triggers an increase in the cash flows otherwise available to the owner under the annuity-LTC contract.

⁵⁶ The Committee's member companies are not aware of any immediate annuity-LTC contracts on the market, but such products were contemplated in connection with the PPA amendments. *See, e.g.*, Mark J. Warshawsky, Assistant Sec'y for Econ. Policy, Dep't of Treasury, Remarks at the Bar of the District of Columbia (Mar. 7, 2006), <http://www.treasury.gov/press-center/press-releases/Pages/20063711531827718.aspx> (discussing the legislation that ultimately became the PPA amendments to section 7702B(e) and stating "[t]he life care annuity combines an immediate life annuity with the disability form of long-term care insurance – the kind of product that the House pension reform bill addresses. In return for a single premium, an insurance company would make steady periodic payments to a retired household (individual or couple), and would increase them substantially when a member of the household becomes disabled to the extent that he would require long-term care services.").

- The LTC insurance coverage could remain available as paid-up coverage in some reduced amount or for some shortened period.
 - The LTC insurance benefits could be subject to any remaining “waiting period” before they become payable. For example, if the annuity-LTC contract is a “tail design,”⁵⁷ and provides that during the annuity accumulation period the first two years of LTC insurance benefits reduce the annuity’s cash value dollar-for-dollar, then the contract might provide that after the annuity starting date LTC insurance benefits comprised of NAR are not payable until two years after the onset of chronic illness.
 - The annuity-LTC contract might be structured so that LTC insurance benefits cease on the scheduled maturity date.
- *Voluntary annuitization prior to the maturity date of a deferred annuity.* Deferred annuities generally provide the owner the right to annuitize the contract prior to the contract’s stated maturity date. If the owner exercises this early annuitization right, the benefits payable pursuant to the QLTCI rider may be affected.
 - In some cases, the LTC insurance benefits may cease in their entirety, leaving only the annuity portion of the contract. This reflects the fact that the owner has decided to use the contract to provide solely retirement benefits thereafter, rather than continued LTC insurance coverage.
 - In other cases, the contract may provide for LTC insurance coverage under a nonforfeiture option, such as a reduced maximum benefit equal to the greater of one month’s coverage or the sum of the prior QLTCI rider charges actually imposed, subject to any limits otherwise specified in the rider.
- *Immediate vs. deferred annuity-LTC contracts.* As described above, while most annuity-LTC contracts available in the marketplace today are based on deferred annuities, those based on immediate annuities have been considered and could be developed in the future. Such a contract design might provide for different types of LTC insurance benefits than one based on a deferred annuity. Perhaps the most likely structure would be for LTC insurance benefits equal to some multiple of the annuity payments becoming payable upon the onset of chronic illness.

B. Accounting for QLTCI charges after the annuity starting date

With respect to charges for a QLTCI rider after the annuity starting date, a variety of contract designs either exist or could exist in the future. In general, however, the following charge structures seem most common or likely:

- *Rider charges cease.* If the annuity-LTC contract is based on a deferred annuity contract, the QLTCI rider charges could cease entirely after the annuity starting

⁵⁷ See *supra* note 4.

date. In such case, continued LTC insurance coverage (if any) under the rider would be fully paid-up.

- *One-time rider charge assessed.* In a deferred annuity-LTC contract, the QLTCI rider could provide for a one-time, lump sum charge against the deferred annuity's cash value immediately prior to annuitization to fund continued LTC insurance coverage on a paid-up basis.⁵⁸
- *Continued charges.* Although less likely considering the benefit structures under the annuity-LTC contract designs available in the marketplace today, it also is conceivable that a QLTCI rider could call for LTC insurance charges after the annuity starting date of a deferred or payout annuity.

The potential tax implications of each of the foregoing charge structures is discussed below.

1. Charges cease or are assessed in a single sum before the annuity starting date

In cases where rider charges cease on or before the annuity starting date, there obviously is no need to account for such charges after the annuity starting date. In cases where a one-time, lump sum rider charge is assessed against a deferred annuity's cash value immediately prior to annuitization in order to fund continued LTC insurance coverage after the annuity starting date, the treatment of the charge is governed by section 72(e)(11). That section provides as follows:

Notwithstanding paragraphs (2), (5)(C), and (10) [of section 72(e)], in the case of any charge against the cash value of an annuity contract ... made as payment for coverage under a qualified long-term care insurance contract which is part of or a rider on such annuity ... contract—

- (A) the investment in the contract shall be reduced (but not below zero) by such charge, and
- (B) such charge shall not be includible in gross income.

Under these provisions, the one-time, lump sum charge against the deferred annuity's cash value immediately prior to annuitization would be treated as a non-taxable distribution from the contract that reduces the owner's IVC (but not below zero).

2. Charges continue after the annuity starting date

In cases where QLTCI rider charges are imposed on or after the annuity starting date, the treatment of such charges may depend on the annuity-LTC contract design, including the charge structure and the type of annuity payments being made. For example:

⁵⁸ As indicated in note 23, *supra*, it is relatively rare for stand-alone QLTCI contracts to be structured as single-premium products because of uncertainty about future morbidity rates. In the case of an annuity-LTC contract, however, a single charge at the annuity contract's scheduled maturity date is more feasible because the expected duration of coverage is significantly shorter.

- If the charges are paid with distributions (or deemed distributions) that are “amounts received as an annuity,” section 72(e)(11) may not apply because it appears that such section, by its terms, applies only to “amounts not received as an annuity,” and it refers to charges assessed “against the cash value of an annuity contract,” whereas many payout annuities may not have an express “cash value.”
- If section 72(e)(11) does not apply, then the distributions (or deemed distributions) that are used to pay the rider charges may be taxable under the normal exclusion ratio rules, or they may qualify for nonrecognition treatment as partial exchanges from the annuity portion to the QLTCI portion of the annuity-LTC contract, based on section 1035 and the “separate contract” rule of section 7702B(e)(1). In either case, the imposition of the charges presumably would have no effect on the exclusion ratio for the contract.
- If section 72(e)(11) does apply, then the distributions (or deemed distributions) that are used to pay the rider charges presumably would (1) be excludable from gross income, and (2) reduce the IVC of the annuity contract (but not below zero). It is not clear how the reduction to IVC might affect the exclusion ratio in such circumstances.

3. Conclusion

In light of the types of annuity-LTC contracts currently in the marketplace, published guidance addressing the treatment of charges imposed after the annuity starting date is not particularly pressing at this point in time. However, as the annuity-LTC contract marketplace evolves, it may become more important to address some of the issues summarized above. Of course, the resolution of these issues could depend heavily on the facts and circumstances, and taxpayers could always seek private letter rulings if their particular annuity-LTC contract designs impose rider charges after the annuity starting date.

C. The Effect of LTC Insurance Benefits on the Exclusion Ratio

The regulations under section 72 provide guidance on the circumstances in which the exclusion ratio for an annuity contract must be re-determined. In particular, Treas. Reg. section 1.72-4(a)(4) states that “[a]fter an exclusion ratio has been determined for a particular contract, it shall be applied to any amounts received as an annuity thereunder unless or until one of the following occurs:

- (i) The contract is assigned or transferred for a valuable consideration (see section 72(g) and paragraph (a) of § 1.72-10);
- (ii) The contract matures or is surrendered, redeemed, or discharged in accordance with the provisions of paragraph (c) or (d) of § 1.72-11;

- (iii) The contract is exchanged (or is considered to have been exchanged) in a manner described in paragraph (e) of § 1.72-11.”

The payment of tax-free LTC insurance benefits under a QLTCI rider to an annuity contract does not implicate any of the foregoing provisions, and therefore should not require a recalculation of the exclusion ratio when such LTC insurance benefits become payable after the annuity starting date.⁵⁹ This conclusion is consistent with the view expressed in Part I above that LTC insurance benefits paid pursuant to a QLTCI rider to an annuity contract are excludable from gross income but do not reduce the IVC of the annuity contract, irrespective of their effect on the amounts otherwise payable under the annuity contract. As discussed above, QLTCI rider benefits are treated as paid under a separate QLTCI contract, rather than the annuity contract, for all federal income tax purposes. As a result, QLTCI rider benefits received after the annuity starting date should not change the exclusion ratio for the annuity contract.⁶⁰ Rather, the original exclusion ratio should continue to apply in the event that QLTCI rider benefits cease (*e.g.*, because the insured recovers from his or her chronic illness or because the maximum rider benefits are paid out) and the original annuity payments resume.⁶¹

IV. Questions Involving Risk Shifting Analysis

Section 4.01(b) of the Notice requests comments on the appropriate analysis in determining whether the LTC feature of an annuity-LTC contract qualifies as an “insurance contract” for tax purposes, so that it may constitute a QLTCI contract.⁶² LTC insurance riders to annuity contracts are subject to regulation by state insurance departments based on standards and rules prescribed by the National Association of Insurance Commissioners. Thus, if the applicable state has approved an LTC rider for use as such, presumably the rider has satisfied whatever requirements the state has deemed necessary in order for it to constitute an insurance contract. Absent a clear reason to disregard that status for tax purposes, the Service should respect the rider’s state law characterization as an insurance contract.

⁵⁹ As discussed on page 23, *supra*, the effect of post-annuitization QLTCI rider charges (as opposed to benefits) on the exclusion ratio is less certain, and may depend on the particular annuity-LTC contract design.

⁶⁰ *See, e.g.*, PLR 7730064, discussed at *supra* note 12 and accompanying text.

⁶¹ We recognize that Treas. Reg. section 1.72-2(b)(2)(ii) states that, in order to constitute “amounts received as an annuity” that are entitled to an exclusion ratio under section 72(b), payments must be made in periodic installments at regular intervals over a period of more than one full year from the annuity starting date. In light of this provision, an alternative view might be that if QLTCI rider benefits commence after the annuity starting date and replace the annuity payments that are otherwise being made for a period of more than one full year, then a new “annuity starting date” occurs if the QLTCI rider benefits later cease and the regularly-scheduled annuity payments resume. If this interpretation were adopted, a new exclusion ratio may need to be calculated as of the new annuity starting date. In the case of life-contingent annuity payments, this generally would be favorable to the taxpayer, as the later annuity starting date would result in a lower “expected return” based on the annuitant’s attained age at the annuity starting date, thereby increasing the exclusion ratio relative to the one calculated at the earlier annuity starting date.

⁶² *See generally* Helvering v. Le Gierse, 312 U.S. 531 (1941) (stating that (1) the form and registration of the contract, (2) the existence of an insurance risk, (3) the shift or transfer of that risk, and (4) the pooling or distribution of the insurance risk by the party assuming it are all relevant factors in considering whether an arrangement constitutes “insurance” for tax purposes).

In addition, we note that the PPA amendments to section 848(e) (regarding the so-called “DAC tax”) establish a significant disincentive to the offering of LTC riders that are devoid of insurance protection. The PPA added paragraph (6) to section 848(e), which provides that a DAC tax rate of 7.7% applies to annuity contracts that include QLTCI features. In contrast, a rate of 1.75% applies to annuity contracts that lack QLTCI features. This significantly increases the cost of selling annuity-LTC contracts relative to annuity contracts, making it highly unlikely that any insurance company would attempt to characterize an annuity that provides no LTC insurance protection as an annuity-LTC contract. In other words, the Code already provides a strong incentive to ensure that annuity-LTC contracts include insurance protection. As a result, there would seem to be little reason to second-guess a state insurance department’s characterization of such a rider as an “insurance contract.”

* * * * *

The Committee appreciates this opportunity to comment on Notice 2011-68 and other tax issues involving annuity-LTC contracts. We will follow up with the Service and Treasury Department in the coming weeks to inquire whether we can be of any further assistance in the government’s consideration of these important issues. In the meantime, if you have any questions, please contact Joe McKeever or Bryan Keene at 202-347-2230.

Sincerely,
Davis & Harman LLP

Attachment

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