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VIA ELECTRONIC MAIL

July 31, 2014

Mr. Karl Walli
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United States Department of the Treasury
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Re: Treatment of Annuity Contracts Under Proposed Section 871(m) Regulations

Dear Mr. Walli:

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") with respect to the treatment of annuity contracts under the proposed section 871(m)[1] regulations relating to dividend equivalent payments from sources within the United States. The Committee is a coalition of life insurance companies formed in 1981 to participate in the development of federal policy with respect to annuities. The Committee's 28 member companies represent approximately 80% of the annuity business in the United States.[2]

We are writing because we are concerned that the proposed regulations could be interpreted as treating payments made under certain annuity contracts to non-resident aliens ("NRAs") as "dividend equivalents." The effect of such a characterization would be to require the issuers of these annuity contracts to withhold the tax imposed by sections 871 and 1441 on the record date of the dividend. The Committee respectfully submits that there is no reason to characterize payments made under annuity contracts as dividend equivalents and that doing so would be inconsistent with other Code provisions. In brief:

1) The dividend equivalent rules are directed at transactions with the potential to avoid the section 1441 withholding tax. Payments made under annuity contracts to NRA policyholders are (and have been for many years) already subject to a comprehensive withholding regime under section 1441. We are not aware of any gaps in that regime

[1] Unless otherwise indicated, references herein to a "section" mean a section of the Internal Revenue Code of 1986, as amended (the "Code").

[2] A list of the Committee's member companies is attached.

with respect to payments made from annuities, *i.e.*, all income (as determined under the rules of section 72) distributed from an annuity to a NRA is already subject to section 1441 withholding.

2) Treating payments from annuity contracts as dividend equivalents is fundamentally inconsistent with the section 72 rules, which govern the taxation of annuity contracts. Section 72 expressly provides that the policyholder of an annuity contract is taxed only when an "amount is received" from the annuity. Requiring 30% withholding as of the record date of the dividend would mean that the dividend would be taxed before there is a payment from the annuity to the policyholder, even though the policyholder is not the legal owner of the underlying investment.

These points are discussed below, following a brief overview of annuity contracts and the relevant tax rules applicable to them.

I. Background

A. *In general*

Insurance companies issue various types of annuity contracts under which the insurer promises to pay benefits in exchange for premiums paid by the policyholder.[3] Under a "variable annuity contract," the benefits payable to the policyholder fluctuate with the investment performance of specified pools of assets in which the insurer invests the premiums.[4] The assets are held and owned by the insurance company in one or more separate accounts established under state insurance law.[5] Under the typical variable annuity, the policyholder can allocate premiums and cash values among a variety of separate account investment options made available by the insurance company. The options typically include various types of equity funds, balanced funds (including target date funds), and fixed income funds. The funds generally are available for investment only to life insurance companies to support the variable contracts they issue and to certain qualified plans.[6] An "indexed annuity contract" is an annuity contract under which the insurer guarantees principal and credits interest based on the performance of one or more specialized indices, commonly the S&P 500.

Both variable annuities and indexed annuities typically have two phases: (1) a deferral (or accumulation) phase, and (2) a payout (or distribution) phase. During the initial deferral phase, premiums and earnings accumulate on a tax-deferred basis, growing the "cash" or "account"

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[3] Our comments address only annuity contracts issued by insurance companies licensed to do business under the laws of any state. The Code refers to such a contract as a "commercial annuity." *See* section 3405(e)(6). (This Code provision encompasses life insurance and endowment contracts also.) Thus, for example, we express no views on the treatment under section 871(m) of a "private annuity."

[4] *See generally* KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE & HEALTH INSURANCE 174 (13th ed. 2000).

[5] Section 817(d).

[6] *See* section 817(h) and Treas. Reg. § 1.817-5(f).

value (often referred to as "inside build-up"). Some or all of the accumulating value can be withdrawn if the policyholder chooses to do so. When the payout stage begins, the cash or account value is converted to a stream of scheduled payments for a specified period, *e.g.*, the life of one or more individuals.

Variable and indexed annuities are first and foremost insurance products. The contracts contain mortality guarantees to protect against longevity risk, and both the contracts and the insurance companies issuing them are subject to comprehensive state regulatory regimes that recognize the unique status of insurance.[7] Moreover, annuities are subject to a special set of Code rules that govern their taxation, as well as that of life insurance and endowment contracts. Those rules are largely set out in section 72, as described next.

B. *Income tax provisions relevant to annuity contracts*

Section 61(a)(9) provides that gross income includes "income" from annuities. Section 72 expands upon that rule and provides that amounts "received" under an annuity contract are includible in gross income.[8] Section 72(b) and (e) provide rules for allocating amounts "received" from an annuity between earnings that are includible in the recipient's gross income and the recovery of premiums paid for the annuity that are excludible from the recipient's gross income. The Service has issued numerous private letter rulings reflecting its well-established position that "section 72 provides a comprehensive scheme for the taxation of life insurance, endowment, and annuity contracts."[9] These rulings have also emphasized that "[b]oth section 72(a) and (e) literally require that amounts be 'received' by the holder before they are included in gross income."[10]

Section 871(a) generally provides that a tax of 30% is imposed on an amount received from U.S. sources by a nonresident alien as interest, dividends, rents, annuities, and other fixed or determinable annual or periodical gains, profits, and income ("FDAP income").[11] FDAP income generally includes all U.S.-source income included in gross income under section 61, except for gain derived from the sale of property, or any other income that the Service

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[7] *See* BLACK & SKIPPER, *supra* note 4, at 949-68.

[8] *See, e.g.*, sections 72(a)(1) and (e)(1)(A).

[9] *See* PLR 201424014 (Mar. 10, 2014); PLR 200742010 (July 19, 2007); PLR 200313016 (Dec. 20, 2002); PLR 200151038 (Sept. 25, 2001); *see also* H.R. REP. NO. 97-760, at 646-47 (1982) (Conf. Rep.) (recognizing that taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn).

[10] *Id.* Congress has specifically provided by statute certain limited circumstances in which amounts are deemed to be received under an annuity contract, *e.g.*, if the policyholder of an annuity pledges it as security for a loan. *See* section 72(e)(4)(A). Otherwise, such amounts must be actually received before they are taxable.

[11] FDAP income does not include an amount that is effectively connected with the conduct of a U.S. trade or business.

determines, in published guidance, is not FDAP income.[12] Income received from an annuity contract is U.S.-source when the issuer of the contract is a domestic corporation.[13]

Treas. Reg. § 1.871-7(a)(2) provides that the "tax of 30 percent is imposed by section 871(a) upon an amount only to the extent the amount constitutes gross income. Thus, for example, the amount of an annuity which is subject to such tax shall be determined in accordance with section 72." Rev. Rul. 2004-75 concludes that income received from an annuity contract under section 72, whether in the form of annuity payments or withdrawals made from the cash value of the contract, is FDAP income. Consistently, Rev. Rul. 2004-75 holds that "[i]ncome received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source FDAP income that is subject to 30% tax and withholding under sections 871(a) and 1441."[14]

II. The Proposed Regulations Could Sweep in Some Annuity Contracts

Section 871(m) provides that a "dividend equivalent" is (1) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; (2) any payment made pursuant to a specified notional principal contract that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; or (3) any other payment determined by the Secretary to be a substantially similar type of payment.

Under the proposed regulations, a "dividend equivalent" includes any payment pursuant to a "specified equity-linked instrument" that references the payment of a dividend from an underlying security.[15] An equity-linked instrument ("ELI") is defined generally as a financial transaction that references the value of one or more underlying securities.[16] The proposed regulations identify certain specific arrangements as ELIs, but also state that any "other contractual arrangement that references the value of one or more underlying securities" is an ELI.[17] A "specified ELI" is any ELI that has a delta of 0.70 or greater when the "long party" acquires the ELI.[18] Under the proposed regulations, the delta is the ratio of the change in the fair market value of the ELI to the change in the fair market value of the property referenced by the contract.[19]

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[12] Treas. Reg. §§ 1.871-7(b)(1), 1.1441-2(b)(1)(i), and 1.1441-2(b)(2).

[13] Rev. Rul. 2004-75, 2004-2 C.B. 109.

[14] The facts of Rev. Rul. 2004-75 involve a foreign branch of a U.S. life insurance company, but the analysis and conclusions of the ruling are equally applicable to a U.S. life insurance company. *See* Rev. Rul. 2009-14, 2009-21 I.R.B. 1031, situation 3.

[15] Prop. Treas. Reg. § 1.871-15(c)(1)(iii).

[16] Prop. Treas. Reg. § 1.871-15(a)(4).

[17] *Id.*

[18] Prop. Treas. Reg. § 1.871-15(e).

[19] Prop. Treas. Reg. § 1.871-15(g).

Given the breadth of the definition of an ELI, a variable annuity contract could be viewed as an ELI because the contract's benefits are based upon the performance of the separate account assets underlying the annuity. If a variable annuity contract is characterized as an ELI, it often would be a "specified ELI" because the ratio of the change in the fair market value of a variable annuity contract to the change in the fair market value of the separate account assets can be close to 1 in many circumstances. Finally, the long party with respect to an ELI is the party that is entitled to the dividend equivalent.[20] The policyholder of a variable annuity contract could be viewed as the "long party" because he or she would be the party entitled to the annuity contract's benefit payments, even though the separate account assets are owned by the insurance company.

For similar reasons, these rules could potentially apply to an indexed annuity contract. For example, an indexed annuity could be viewed as an ELI if the contract's benefits were determined by reference to an index other than a "qualified index" as defined in Prop. Treas. Reg. § 1.871-15(k).

In short, while presumably an unintended result, under the regulations as proposed under section 871(m), payments made with respect to these types of annuity contracts could be characterized as dividend equivalents. As discussed in the next section of this letter, such a characterization lacks a policy basis and is in any event inconsistent with section 72. Accordingly, we request that the final regulations make clear that the dividend equivalent regulations do not apply to annuity contracts.

III. The Final Dividend Equivalent Regulations Should Not Apply to Annuity Contracts

A. *Payments from an annuity contract to a NRA are already subject to withholding*

The dividend equivalent rules are directed at transactions with the potential to avoid the section 1441 withholding tax. This is reflected in the scant legislative history of section 871(m), but also in the preamble to the proposed regulations.[21] A NRA policyholder cannot avoid the section 1441 withholding tax by buying an annuity.

As described above, payments from annuity contracts to NRA policyholders are already subject to a comprehensive withholding regime under section 1441. All income (as determined under the rules of section 72) distributed from an annuity to a NRA is subject to the section 1441

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[20] Prop. Treas. Reg. § 1.871-15(a)(7)(i).

[21] *See* STAFF OF J. COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN SENATE AMENDMENT 3310, THE "HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT," UNDER CONSIDERATION BY THE SENATE 78 n.317 (Comm. Print 2010) ("There is evidence that some taxpayers have taken the position that Notice 97-66 [relating to substitute dividend payments] sanctions the elimination of withholding tax in certain situations."); *see also* Dividend Equivalents From Sources Within the United States, 78 Fed. Reg. 73128, 73132 (proposed Dec. 5, 2013) ("A transaction has the 'potential for tax avoidance' if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security.").

withholding rules. This conclusion is made clear in the statute and regulations[22] and is confirmed by holding (1) of Rev. Rul. 2004-75:

> Income received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source FDAP income that is subject to 30% tax and withholding under sections 871(a) and 1441.

Given the existing withholding rules for payments from annuities, it would make no sense from a policy perspective to characterize such payments as dividend equivalents.[23] Moreover, as discussed next, such a characterization would be contrary to the comprehensive scheme for the taxation of life insurance, endowment, and annuity contracts prescribed by Congress under section 72.

B. *Income from an annuity contract is taxable only when received*

Treating payments made from annuity contracts as dividend equivalents would be fundamentally inconsistent with section 72. Section 72 expressly provides that the policyholder of an annuity contract is taxed only when an "amount is received" from the annuity. As described above, this position is well established in the tax law and reflected in various rulings the Service has issued.[24] If payments from an annuity contract are characterized as dividend equivalents, that would necessarily mean that withholding tax would be imposed on an amount credited to the cash value of an annuity contract before any payment is made to the policyholder, *i.e.*, before any amount is received under the annuity.

Under the proposed regulations, withholding of the 30% tax under section 1441 is generally required at the later of the time the amount of the dividend equivalent is fixed, *i.e.*, the record date of the dividend on the underlying security, or the time the withholding agent has "custody or control" over property of the long party.[25] For example, in the case of a variable annuity contract, this would appear to mean that withholding would be required as of the record date of the dividend in the underlying security, because the insurer holds the contract's cash value in its separate account. In short, if payments under an annuity contract are characterized as dividend equivalents, the proposed regulations would require an amount to be withheld from the annuity's cash value even though no amount has been "received" under the contract. Such

[22] *See* section 871; Treas. Reg. § 1.871-7(a)(2).

[23] Such characterization would also undoubtedly give rise to a myriad of complex and difficult issues with respect to the relationship of the existing withholding regime with the withholding regime created by the proposed regulations. The administrative challenges – both to life insurance companies and the Service – would be equally complex and difficult.

[24] *See supra* notes 9-10 and accompanying text.

[25] Prop. Treas. Reg. § 1.1441-2(d)(5).

treatment is clearly inconsistent with section 72 and effectively would tax the "inside build-up" of the annuity contract.[26]

IV. Conclusion and Recommendation

For the foregoing reasons, the Committee respectfully requests that the final regulations make clear that annuity contracts are not subject to the dividend equivalent regulations under section 871(m). This clarification could be made in a number of different ways. However, we recommend that the final regulations include a provision stating that an "equity linked instrument" (as defined in Prop. Treas. Reg. § 1.871-15(a)(4)) does not include a "commercial annuity" as defined in section 3405(e)(6). The Committee believes that this clarification will prevent payments from annuity contracts issued by state licensed insurance companies, which are already subject to the section 1441 withholding tax, from also being viewed as dividend equivalent payments.

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We appreciate this opportunity to offer input on the proposed regulations under section 871(m). If you have any questions, or if we can be of any assistance in your consideration of the issues summarized above, please do not hesitate to contact either of the undersigned at 202-347-2230.

Sincerely,

Joseph F. McKeever, III — Alison R. Peak

Counsel to the Committee of Annuity Insurers

Attachment

cc: Lori Robbins, Attorney-Advisor, Office of Tax Policy, Treasury Department
Helen Hubbard, Associate Chief Counsel, Financial Institutions & Products, IRS
Sheryl Flum, Branch Chief, Branch 4, Financial Institutions & Products, IRS
Donald Drees, Senior Technical Reviewer, Branch 4, Financial Institutions & Products, IRS
Mark Erwin, Branch Chief, Branch 5, International, IRS
Peter Merkel, Senior Technical Reviewer, Branch 5, International, IRS
Karen Walny, Advisor, Branch 5, International, IRS

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[26] *See* House Ways & Means Committee Chairman Dave Camp's Executive Summary of the discussion draft of The Tax Reform Act of 2014, pg. 27 (recognizing Congress' "long-standing practice of exempting 'inside build-up'" from taxation), *available at* http://waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf.

THE Committee OF Annuity Insurers
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Voya Financial, Inc., Atlanta, GA

The Committee of Annuity Insurers was formed in 1981 to participate in the development of federal tax and securities law policies with respect to annuities. The member companies of the Committee represent approximately 80% of the annuity business in the United States.