DAVIS &
HARMAN LLP

ATTORNEYS AT LAW

THE WILLARD
1455 PENNSYLVANIA AVENUE, NW, SUITE 1200
WASHINGTON, DC 20004

TEL 202-347-2230
FAX 202-393-3310 WWW.DAVIS-HARMAN.COM

VIA ELECTRONIC DELIVERY

May 31, 2017

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2017-28)
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Recommendations for 2017-2018 Priority Guidance Plan

To whom it may concern:

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") in response to the invitation in Notice 2017-28[1] for public recommendations of items to include on the 2017-2018 Priority Guidance Plan. The Committee is a coalition of life insurance companies formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of federal policy with respect to tax, securities, and banking law issues affecting annuities. The Committee's current 29 member companies represent over 80% of the annuity business in the United States. A list of the Committee's member companies is attached.

Pursuant to the statement in Notice 2017-28 that it would be helpful if taxpayers suggesting more than one guidance project prioritize the projects by order of importance, we address our highest priority item first, followed by three additional items on which guidance is needed. The four items are:

Highest Priority Item:	• Guidance relating to the treatment of annuity payments under the section 401(a)(9) required minimum distribution ("RMD") regulations.[2]
Additional High-Priority Items:	• Guidance on the circumstances in which annuity payments constitute substantially equal periodic payments ("SEPPs") within the meaning of sections 72(t)(2)(A)(iv) and 72(q)(2)(D).

[1] 2017-19 I.R.B. 1235.

[2] Unless otherwise indicated, each reference to a "section" means a section of the Internal Revenue Code of 1986, as amended.

- Guidance on certain matters relating to qualifying longevity annuity contracts ("QLACs") under Treas. Reg. section 1.401(a)(9)-6.

- Guidance on certain matters involving the relationship of annuities and long-term care insurance contracts.

The Committee strongly urges that the 2017-2018 Priority Guidance Plan include the items described below. The need for guidance on each of these items and why each satisfies the criteria for inclusion in the Priority Guidance Plan are discussed in connection with each item.

We wish to emphasize that issuing guidance on these items is fully consistent with, and would help the Treasury Department and the Internal Revenue Service implement, President Trump's regulatory reform agenda. For example, Executive Order 13777 ("Enforcing the Regulatory Reform Agenda") directs each agency to establish a Regulatory Reform Task Force and a Regulatory Reform Officer to identify regulations that are "outdated, unnecessary, or ineffective."[3] The provisions of the section 401(a)(9) RMD regulations that we advocate changing are a compelling example of outdated, unnecessary, and ineffective regulations. Furthermore, those provisions certainly "add undue complexity to the Federal tax laws," while our proposed changes would provide "useful, simplified tax guidance" to taxpayers. See Executive Order 13789 ("Identifying and Reducing Tax Regulatory Burdens").[4]

<u>Treatment of Annuity Payments Under Section 401(a)(9)</u>

Over the last 10 years there has been an ever increasing need to correct two aspects of the RMD regulations applicable to annuity income payments: (1) the minimum income threshold test,[5] and (2) the rigid rules regarding permissible intervals between annuity payments.[6] As described below, these rules are outdated. Moreover, in their current form they do not serve their intended purpose and instead act as significant barriers to retirees seeking the security that can be obtained only by the purchase of a life annuity.

(a) The minimum income threshold test

The regulations under section 401(a)(9) require annuity payments to be non-increasing, subject to certain exceptions.[7] Other than in the case of certain cost of living adjustments, any form of increasing payment under the annuity must meet a minimum income threshold test (the "MITT").[8] For example, the MITT applies to commercial annuity contracts that (i) provide for

---

[3] Exec. Order No. 13777, 82 Fed. Reg. 12,285 (Mar. 1, 2017).

[4] The quoted benchmarks for regulatory reform are articulated for use in connection with the mandated review of tax regulations issued on or after January 1, 2016, but the policy judgment they reflect is equally relevant to other Treasury regulations.

[5] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(c).

[6] Treas. Reg. section 1.401(a)(9)-6, Q&A-1(a), Q&A-14(c)(4) and (e)(4).

[7] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(a).

[8] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(c).

annuity payments that increase by a constant percentage each year (*e.g.*, 3%), (ii) provide for annuity payments that may increase due to dividends (*i.e.*, participating annuities), (iii) provide an acceleration option such as a partial or full commutation, and (iv) provide a cash refund payable on the annuitant's death.[9] The MITT requires that the total future expected payments, ignoring any increases following the first payment, must exceed the total value being annuitized.[10] The preamble to the regulations explains that the MITT is designed to ensure "that annuity payments start at a high enough amount to prevent inappropriate deferral."[11]

In many circumstances certain traditional forms of annuity payments can no longer satisfy the MITT. For example, a level-payment life annuity with a return of premium death benefit can fail the test if issued to a 72-year-old. *This means that this individual cannot buy a life annuity with a return of premium death benefit at that time because, if purchased, the annuity would immediately violate the RMD regulations.* The circumstances in which this failure occurs are arbitrary, and we believe were not intended by the authors of the regulations. Indeed, in some cases an annuity benefit that if purchased 10 years ago by, *e.g.*, a 72 year old individual, would have satisfied the MITT will not do so if purchased by a 72 year old now. In no small part, this is due to the low interest rate environment and mortality improvements developed after the regulations were issued. *In sum, the MITT is not only outdated, but because it is outdated it precludes the purchase of annuities that it was never intended to preclude.*

The Committee believes that appropriate exceptions to the MITT can and should be made to address the following situations:

- A cash refund on the annuitant's death. A lump sum payment at death accelerates the time at which the decedent's interest will be distributed. As a result, this type of benefit should not be subject to the MITT. In fact, from 1987 until the regulations were amended in 2004 a cash refund was permitted without regard to the MITT.[12] Permitting a commercial annuity to provide such a benefit also would be consistent with the treatment of defined benefit plans under the regulations.[13]

- Partial and full commutations. Commutations also accelerate the time at which a participant's interest will otherwise be distributed under the contract. Thus, like a cash refund death benefit, a commutation should not be treated as involving the type of increasing payments that present a concern about inappropriate deferral.

- Annuity payments that increase annually by a modest fixed percentage, *e.g.*, up to 5%. This would enable the purchase of annuities that protect against inflation and would be

---

[9] *Id*.

[10] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(c), (e)(1), and (e)(3).

[11] 69 Fed. Reg. 33291 (June 15, 2004).

[12] Prop. Treas. Reg. section 1.401(a)(9)-1, F-3(a)(3) (1987); Prop. Treas. Reg. section 1.401(a)(9)-6, Q&A-1(a)(3) (2001).

[13] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(d)(2).

consistent with the annual annuity increases that the regulations currently allow for defined benefit plans.[14]

- Reasonable dividends under participating annuities. Dividends determined with respect to reasonable investment, mortality, and expense assumptions under a participating contract should not be subject to the MITT.

Adopting these exceptions would also remove considerable complexity from the existing regulations and the resulting simplicity would significantly benefit older individuals seeking to buy a life annuity. This is because they would no longer have to confront a situation where they are told by an insurer that “Due to the RMD regulations, you cannot buy a life annuity this year, although you could have bought it two years ago, and if you wait five more years, you may be able to buy the annuity then.”

(b) Flexibility on the timing of annuity RMD payments

An IRA owner or employee is permitted to take his RMD for a calendar year with respect to an individual account at any time during the calendar year.[15] In addition, an individual is not required to take withdrawals from an individual account in uniform intervals during a year or from year to year (*e.g.*, an individual may withdraw an RMD in a single lump sum at the beginning of one calendar year, in a single lump sum at the end of another calendar year, and in installments throughout another calendar year). This flexibility is obviously helpful and desirable to some elderly individuals because they can accelerate some or all of their account-based RMDs for the year if they have an unexpected financial need during the year.

Annuity issuers would like to provide IRA owners and employees who annuitize part of their retirement savings with similar flexibility. Some commercial annuities already allow owners to accelerate, or advance, one or more annuity payments scheduled to be made within a specified period of time, *e.g.*, within a contract year. Although annuity payments can be accelerated in some cases under the RMD regulations, it appears that the acceleration must shorten the annuity period or reduce the amount of the payments to be made under the annuity.[16] A more limited form of acceleration, *e.g.*, the receipt in January of the monthly payments for February and March, would affect only the timing within a year of the payments, *i.e.*, neither the duration of the annuity period nor the sum of the payments that will be made under the annuity is reduced, and thus may run afoul of the regulations. In addition, the regulations can be read as precluding a change in the interval between annuity payments even though the change is only temporary and results only in an acceleration of payments.[17]

We believe this matter can be easily addressed by modifying the RMD regulations to clarify that a short-term advancement of annuity payments is not subject to the limitations on

---

[14] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(d)(1).

[15] Treas. Reg. section 1.401(a)(9)-5, Q&A-1(c).

[16] Treas. Reg. section 1.401(a)(9)-6, Q&A-14(c)(4) and (e)(4).

[17] Treas. Reg. section 1.401(a)(9)-6, Q&A-1(a).

increasing annuity payments and will not result in a change in the interval between annuity payments. *Importantly, such a clarification would remove a restriction on the frequency of annuity payments which is completely unnecessary in these circumstances.* It would also reduce the disparate treatment of individual accounts and annuities under the regulations.

Annuity Payments as SEPPs

Guidance also is needed to address the treatment of annuity payments as substantially equal periodic payments, *i.e.*, SEPPs. Since 2011-2012, the Priority Guidance Plan has included an item regarding guidance on "exceptions to additional tax under §72(t) on early distributions from retirement plans and IRAs." It is our understanding that this item encompasses guidance clarifying when annuity payments constitute SEPPs, and thus are exempt from the 10% penalty that otherwise would apply if the taxpayer is younger than age 59½.

Prior to the issuance of a private letter ruling in 2011, life insurance companies and financial advisors widely believed that annuity payments that satisfy the required minimum distribution ("RMD") rules under Treas. Reg. section 1.401(a)(9)-6 also constitute SEPPs. This belief was based on Q&A-12 of Notice 89-25,[18] as modified by Rev. Rul. 2002-62.[19] However, in PLR 201120011 (Feb. 11, 2011), the Service took the position that the RMD method described in Q&A-12 of Notice 89-25 was superseded by the RMD method described in Rev. Rul. 2002-62.

The significance of the Service's position in PLR 201120011 is that the RMD method described in Rev. Rul. 2002-62 is limited to contracts with an "account balance," and thus does not encompass annuity payments because those payments typically are made under a contract without an account balance. Although PLR 201120011 involved the treatment of annuity payments under nonqualified annuities as SEPPs within the meaning of section 72(q)(2)(D), the conclusions and reasoning of the ruling extend to the treatment of annuity payments under annuity contracts used in connection with qualified retirement plans and IRAs as SEPPs within the meaning of section 72(t)(2)(A)(iv).[20] The Service's position that the RMD method of Rev. Rul. 2002-62 excludes annuity payments effectively means that there is no published guidance on when annuity payments (including life-contingent annuity payments) will constitute SEPPs.

Whether annuity payments constitute SEPPs is a very significant issue for owners (and prospective owners) of IRA annuity contracts,[21] section 403(b) annuity contracts, and nonqualified annuity contracts, the insurance companies that issue those contracts, and employer plans that use commercial annuities to distribute benefits to employees. The Committee urges the Treasury Department and the Service to provide guidance on this issue.

---

[18] 1989-1 C.B. 662.

[19] 2002-2 C.B. 710.

[20] Notice 2004-15, 2004-9 C.B. 526, effectively provides that payments from a nonqualified annuity will be treated as satisfying section 72(q)(2)(D) only if they satisfy section 72(t)(2)(A)(iv) ("The IRS and Treasury believe that because these provisions were enacted for the same purpose it is appropriate to apply the same methods to determine whether a distribution is part of a series of substantially equal periodic payments.").

[21] As used herein, "IRA annuity" means an individual retirement annuity under section 408(b).

Qualifying Longevity Annuity Contracts (or QLACs)

The Committee also believes there is a pressing need for guidance addressing certain technical issues in the regulations under section 401(a)(9) regarding the purchase of QLACs under certain types of qualified retirement plans and IRAs. These regulations, released on July 1, 2014,[22] are important because they removed an impediment under the existing regulations that effectively precluded the offering of longevity insurance in these types of arrangements. However, technical issues exist under the regulations that continue to impose barriers to the use of QLACs. For the reasons discussed below, the Committee requests that the 2017-2018 Priority Guidance Plan include guidance on the following two issues, each of which discourages and impedes the use of QLACs to provide life annuities to plan participants and IRA owners.

(a) Clarify the QLAC premium limits to facilitate purchases *via* rollovers to IRAs

QLACs are readily available in the IRA market, but it is rare for a qualified plan to offer a QLAC option directly. As a result, the only way for virtually any participant in a qualified plan to obtain a QLAC is by rolling money out of the plan to an IRA. In the IRA market, a QLAC typically is issued as a contract that also qualifies as an IRA annuity under section 408(b), which obviates the need for the QLAC to be held within an individual retirement account under section 408(a). Unfortunately, there is considerable uncertainty regarding how the limits on QLAC premiums in the regulations apply when an amount is rolled from a qualified plan to an IRA in order to obtain a QLAC. This uncertainty is having a significantly adverse effect on the availability of QLACs in the marketplace.

In that regard, the regulations limit the premiums that an individual can pay for a QLAC to the lesser of $125,000 or 25% of the account balance under the plan or IRA.[23] The $125,000 limit applies across all types of arrangements, whereas the 25% limit applies separately to each qualified plan in which the individual participates and collectively to all IRAs that an individual owns.[24] For purposes of the 25% limit, the account balance of a qualified plan is determined as of the most recent valuation date and is adjusted up or down to reflect subsequent contributions or distributions.[25] In contrast, the account balance of an IRA is determined as of December 31st of the previous calendar year, and there is no specific mention of any adjustment for subsequent contributions or distributions.[26]

When a QLAC is purchased in a direct rollover from a qualified plan to an IRA, it is not clear which account balance should be used when applying the 25% limit. In other words, it is not clear whether the regulations limit the purchase to 25% of the individual's account balance in the plan or 25% of the account balance in the individual's IRAs. If the limit applies based on the

[22] 79 Fed. Reg. 37633 (July 2, 2014).

[23] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(a)(1) and (b).

[24] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(b); Treas. Reg. section 1.408-8, Q&A-12(b)(3).

[25] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(d)(1)(iii).

[26] Treas. Reg. section 1.408-8, Q&A-12(b)(3)(i).

IRA account balance, the QLAC purchase could be unnecessarily complicated and delayed. Moreover, in many cases the individual would need to quadruple the amount of the rollover just to facilitate the QLAC purchase. These problems are illustrated in the following example:

> Assume that an individual has a $500,000 account balance in her former employer's qualified plan. She wants to use 10% of that balance, or $50,000, to purchase a QLAC, but her plan does not offer one. She decides to roll the money from the plan to purchase a QLAC that also qualifies as an IRA annuity. However, she currently does not own any IRAs. If the 25% limit on QLAC premiums applies based on her IRA account balance (which is zero), she will need to roll <u>$200,000</u> from her plan just to facilitate the $50,000 QLAC purchase. Moreover, because the regulations measure her IRA account balance as of the prior year-end (which, again, was zero), she will need to roll the $200,000 from the plan to an IRA, wait until the next year, then transfer $50,000 from the IRA to a QLAC that qualifies as an IRA annuity. After the transaction, the individual would own a QLAC that clearly complies with the intent of the premium limits, but would have unnecessarily moved $150,000 from her plan to an IRA and would have suffered a considerable delay and possibly additional expense in obtaining the QLAC.

Unfortunately, the market is generally interpreting the regulation conservatively and is applying the cumbersome approach described in the example above. This, in turn, is having a significantly adverse effect on the ability of individuals to protect themselves against longevity risk through the purchase of a QLAC. The solution to this problem would be for the Service to issue guidance clarifying that the 25% limit applies based on the account balance in the plan in the following circumstances. The guidance could describe a situation like the one in the example above, involving a direct rollover from a plan to an IRA for the specific purpose of purchasing a QLAC. The guidance would then clarify that in such a situation the 25% limit is applied based on the account balance in the plan as of the most recent valuation date occurring immediately before the rollover, not the prior year-end account balance in the IRA. This would merely clarify which of two existing rules in the regulations applies to the transaction. Moreover, in the direct rollover context where the distribution is used to directly purchase a QLAC, treating the distribution as coming from the plan for purposes of the 25% limit is entirely consistent with the structure of the section 401(a)(9) regulations, which state that in the context of a rollover, "the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover."[27]

Thus, the regulations would not need to be amended. In addition, the transaction would be reported on existing forms without the need for the Service to amend those forms.[28]

---

[27] Treas. Reg. section 1.401(a)(9)-7, Q&A-1.

[28] Specifically, the applicable IRS forms would be Form 1099-R (reporting the direct rollover), Form 5498 (reporting the contribution to the IRA annuity that qualifies as a QLAC), and Form 1098-Q (reporting the premiums and other information regarding the QLAC).

(b) Clarify spousal death benefits in the event of divorce

The QLAC regulations prescribe very different rules depending upon whether the owner's beneficiary is his or her spouse. If a QLAC owner's sole beneficiary is his or her spouse, the contract can provide *both* a lump sum return of premium death benefit *and* a 100 percent survivor annuity.[29] However, if the owner's sole beneficiary under a QLAC is not his or her spouse, the contract can provide *either* a lump sum return of premium death benefit *or* a survivor annuity (but not both), and a non-spouse survivor annuity is subject to a required reduction in the annuity payments after the owner's death.[30]

Unfortunately, the regulations do not address how these death benefit rules apply if the beneficiary is the owner's spouse when the contract is issued, but because of a subsequent divorce is no longer the owner's spouse when annuity payments commence or when the owner dies.[31] If a beneficiary's status as a spouse or non-spouse is determined after a QLAC is issued, *e.g.*, on the date annuity payments commence, a contract that was issued with permissible benefits might be viewed as providing impermissible benefits merely because of the divorce.

If a contract that is intended to be a QLAC provides impermissible benefits, the value of the contract must be included in the account balance used to determine the owner's required minimum distributions. To prevent this potential adverse and unintended result, in theory the issuer could modify the contract's benefits after the divorce, but this may be difficult or impossible. The price and benefits can differ materially based on whether the spouse or non-spouse rules apply, and insurers need to know which rules will apply so they can price the product at issuance and so the purchaser will know what they are getting for what price. If a contract failed to be a QLAC following the divorce, the owner could become liable for a 50% excise tax under section 4974. The mere possibility that this problem can arise in the event of a divorce after a QLAC is purchased may prevent a QLAC issuer from offering the fullest permissible death benefit to a spouse beneficiary.

The solution to this problem would be for the Service to issue guidance clarifying that a divorce occurring after a QLAC is purchased but before payments commence will not affect the permissibility of the joint and survivor benefits previously purchased under the contract if a qualified domestic relations order ("QDRO") (in the case of a retirement plan) or a divorce or separation instrument (in the case of an IRA) provides that the former spouse is entitled to the promised spousal benefits under the QLAC. Such a clarification would be consistent with a general rule that already exists in the section 401(a)(9) regulations, which provides that a former spouse is treated as a spouse for purposes of the minimum distribution requirements if certain requirements are met. That rule states:

---

[29] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(c)(1).

[30] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(c)(2).

[31] *Compare* Treas. Reg. section 1.401(a)(9)-6, Q&A-2(b) (spousal status is determined "as of the annuity starting date for annuity payments") and Treas. Reg. section 1.401(a)(9)-5, Q&A-4(c)(2) (spousal status for individual accounts is re-determined on January 1st of each year).

> A former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417.[32]

It appears, though not clearly, that this general rule applies to QLACs, but in light of the repercussions of being wrong on this point, the market appears to have generally taken a conservative position on the application of the rule to QLACs, which makes selling QLACs in the plan context very difficult. Accordingly, it is very important that there is confirmation that the above quoted general rule applies to QLACs in the plan context.

In addition, although QDROs are a concept applicable to employer-sponsored plans and not IRAs, a parallel concept should apply to IRAs, but obviously without regard to the technical requirements that apply to QDROs. Applying a parallel concept to IRAs is supported by the existing regulatory provision that, except as otherwise provided, all of the section 401(a)(9) rules for plans apply to IRAs.[33] As a result, clarification that such a parallel concept regarding former spouses applies for purposes of QLACs issued in the IRA market would be both appropriate and very helpful in addressing an uncertainty that has inhibited the QLAC/IRA market. Such a clarification could provide that "divorce or separation instruments"[34] can cause a former spouse to be treated as the spouse for minimum distribution purposes, including QLACs, in the same manner as a QDRO.

For IRAs, spousal rights may continue after a divorce in two distinct ways. First, a former spouse may have rights under the contract which remain pursuant to a divorce or separation instrument. Second, the former spouse may be contractually entitled to benefits originally purchased under the contract which remain unchanged after a divorce or separation. In the latter case, the parties may not think they need to specify in the divorce or separation agreement that the former spouse will continue to be the beneficiary of the QLAC upon the owner's death. For this reason, the guidance would have an even broader and more appropriate effect if it could also clarify that, even in the absence of a formal divorce or separation instrument that addresses the contract, a former spouse is treated as the spouse for purposes of the QLAC requirements as long as the former spouse remains contractually entitled to the benefits originally purchased under the contract following the divorce.

These clarifications would ensure that former spouses can be protected both in plans and IRAs. Moreover, because these clarifications are consistent with the existing regulations and would merely explain how those regulations apply to QLACs, the clarifications could be provided through IRS guidance without having to amend the regulations.

---

[32] Treas. Reg. section 1.401(a)(9)-8, Q&A-6(a).

[33] *See* Treas. Reg. section 1.408-8, Q&A-1

[34] This term would have the meaning set forth in section 71(b)(2).

Annuities and Long-Term Care Insurance Contracts

The Committee believes there is a pressing need for guidance clarifying ambiguities in the federal income tax treatment of transactions involving annuities and qualified long-term care insurance ("QLTCI") contracts. Such transactions are gaining popularity as Americans age and more individuals seek the protections that these insurance products provide. As a result, guidance on these issues would resolve significant issues relevant to many taxpayers and the insurance companies that issue and administer these products. In addition, such guidance would promote sound tax administration by facilitating uniformity in how life insurance companies tax report the relevant transactions and by facilitating better understanding by individual taxpayers and their advisors of the tax consequences of those transactions.

(a) Exchanges Involving Annuities and QLTCI Contracts

Since 2011-2012, the Priority Guidance Plan has included an item regarding guidance on "exchanges under §1035 of annuities for long-term care insurance contracts." The Committee requests that the Treasury Department and the Service carry this item over to the 2017-2018 Priority Guidance Plan, as there are several issues on this topic for which guidance is still needed. In 2011, the Service issued Notice 2011-68,[35] which requested public comment on, *inter alia*, the treatment of exchanges of annuity contracts for QLTCI contracts. In November 2011, the Committee filed a letter with the Service in response to the Notice. In our letter, we asked for guidance on the following issues involving annuity-for-QLTCI contract exchanges.

- *Partial exchanges of deferred annuities*—Partial exchanges are often the only effective means of exchanging an annuity for a QLTCI contract because the latter type of contract typically requires multiple premium payments over time. Notice 2011-68 was helpful in confirming that a partial exchange of a deferred annuity for a QLTCI contract is entitled to nonrecognition treatment under section 1035, and that the adjusted basis, under section 1031(d), of a QLTCI contract received in a tax-free section 1035 exchange of an annuity generally carries over from the contract being exchanged. The Notice did not, however, address other significant issues that can arise with respect to such partial exchanges. In particular, guidance is needed:

  (a) to confirm how the "investment in the contract" and adjusted basis is apportioned between the deferred annuity and QLTCI contract, and

  (b) to confirm that Rev. Proc. 2011-38,[36] regarding the partial exchange of an annuity for another annuity, does not apply to partial exchanges involving an annuity-QLTCI combination contract or a stand-alone QLTCI contract.

- *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

[35] 2011-36 I.R.B. 205.

[36] 2011-30 I.R.B. 66.

order for an exchange to receive nonrecognition treatment under that section. The regulations were promulgated in 1956,[37] however, and have not been updated to reflect the 2006 amendments to section 1035 that permit tax-free exchanges involving QLTCI contracts.[38] Thus, questions can and do 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.[39] As a result, life insurance companies, policyholders, and financial advisors cannot be certain what requirements must be met to assure that such exchanges are tax-free. The regulations need to be updated to reflect these changes in law.

- *Exchanges of payout annuities for QLTCI contracts*—Notice 2011-68 asked 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 asked:

  (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 "investment in the contract" be apportioned between the QLTCI contract received in the exchange and the rights retained in the annuity after the exchange?

  Guidance on these issues is needed because in many cases an exchange of a payout annuity (or a series of partial exchanges involving a payout annuity) may be the most viable method of exchanging an annuity for a QLTCI contract that requires multiple premium payments for long durations, possibly for life.

The Committee continues to believe there is a pressing need for guidance addressing each of the foregoing issues. As a result, we ask the Treasury Department and the Service to carry over the prior years' general guidance item to the 2017-2018 Priority Guidance Plan, and in doing so ensure that each of the foregoing specific issues is considered as part of the guidance item.

(b) Combination Annuity-QLTCI Contracts

Since 2009-2010, the Priority Guidance Plan has included an item regarding "guidance on annuity contracts with a long term care insurance feature or rider." While Notice 2011-68 provided helpful guidance on some outstanding questions, other significant questions remain and

---

[37] T.D. 6211, 1956-2 C.B. 29.

[38] The Pension Protection Act of 2006, Pub. L. No. 109-280, § 844 (2006) ("PPA 2006").

[39] Treas. Reg. section 1.1035-1 (flush language).

need to be addressed through additional guidance. In our November 2011 comment letter on Notice 2011-68, the Committee identified a number of such additional issues needing guidance.

- *Tax-free nature of QLTCI benefits*—By their nature, annuity-QLTCI combination contracts involve certain interactions between the QLTCI and annuity benefits under the contract. For example, a QLTCI rider to a deferred annuity might provide for QLTCI benefits that reduce the annuity's cash value by some amount. Based on the statutory structure and legislative history, the general understanding is that such QLTCI 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 Service has confirmed this conclusion in two private letter rulings.[40] However, there is no published guidance on this point on which all taxpayers can rely.

- *Effect of QLTCI benefits on "investment in the contract"*—Because benefits paid under the QLTCI portion of an annuity-QLTCI combination 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" of the annuity portion. Although the PPA 2006 did not explicitly address this question, the Service concluded in a 2009 private letter ruling that such rider benefits will reduce the investment in the contract of the annuity portion of the contract.[41] This view is not shared by the Committee. Moreover, the Committee is concerned that some taxpayers may feel compelled to follow the view expressed in the 2009 private letter ruling, while others may adopt a contrary view. 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-QLTCI combination contract, published guidance is needed.

Like the section 1035 issues discussed above, the Committee continues to believe that each of the foregoing issues regarding annuity-QLTCI combination contracts needs to be addressed in guidance. It is our understanding that the lack of guidance and the uncertainty surrounding the aforementioned private letter rulings have discouraged life insurance companies from developing new annuity-QLTCI combination products. As a result, we ask the Treasury Department and the Service to carry over last year's general guidance item to the 2017-2018 Priority Guidance Plan, and in doing so ensure that each of the foregoing specific issues is considered as part of the guidance item.

* * * * *

[40] PLR 201213016 (Dec. 20, 2011); PLR 200919011 (Feb. 2, 2009).

[41] PLR 200919011 (Feb. 2, 2009).

We appreciate this opportunity to offer input on the 2017-2018 Priority Guidance Plan. 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 any of the undersigned at 202-347-2230.

Sincerely,

Joseph F. McKeever | Mark E. Griffin | Bryan W. Keene

Counsel to the Committee of Annuity Insurers

Attachment

THE Committee OF Annuity Insurers
www.annuity-insurers.org

AIG Life & Retirement, Los Angeles, CA
Allianz Life Insurance Company, Minneapolis, MN
Allstate Financial, Northbrook, IL
Ameriprise Financial, Minneapolis, MN
Athene Annuity & Life Company, Des Moines, IA
AXA Equitable Life Insurance Company, New York, NY
Fidelity Investments Life Insurance Company, Boston, MA
Genworth Financial, Richmond, VA
Global Atlantic Life and Annuity Companies, Southborough, MA
Great American Life Insurance Co., Cincinnati, OH
Guardian Insurance & Annuity Co., Inc., New York, NY
Jackson National Life Insurance Company, Lansing, MI
John Hancock Life Insurance Company, Boston, MA
Lincoln Financial Group, Fort Wayne, IN
MassMutual Financial Group, Springfield, MA
Metropolitan Life Insurance Company, New York, NY
National Life Group, Dallas, TX
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Northwestern Mutual Life Insurance Company, Milwaukee, WI
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Protective Life Insurance Company, Birmingham, AL
Prudential Insurance Company of America, Newark, NJ
Symetra Financial, Bellevue, WA
The Transamerica companies, Cedar Rapids, IA
TIAA, New York, NY
USAA Life Insurance Company, San Antonio, TX
Voya Financial, Inc., Atlanta, GA

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