

Part III - Administrative, Procedural, and Miscellaneous

Annuity and Life Insurance Contracts with a Long-Term Care Insurance Feature

Notice 2011-68

SECTION 1. PURPOSE

This notice relates to amendments made to §§ 72, 1035, and 7702B of the Internal Revenue Code by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"). These amendments affect qualified long-term care insurance, annuity, and life insurance contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009, and tax-free exchanges occurring after December 31, 2009. This notice provides interim guidance on the application of these amendments in certain circumstances, and requests comments on certain other issues to be addressed in future guidance concerning the taxation of annuity and life insurance contracts with a long-term care insurance feature.

SECTION 2. BACKGROUND

.01 Section 72 sets forth rules for the income taxation of amounts received under an annuity, endowment, or life insurance contract.

.02 Section 72(a) provides that gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. Section 72(b), however, excludes from gross income that part of an amount received as an annuity

that bears the same ratio to that amount as the investment in the contract bears to the expected return under the contract (determined as of the annuity starting date). For this purpose, investment in the contract is defined in § 72(c)(1) to equal the aggregate amount of premiums or other consideration paid for the contract as of the annuity starting date, minus the aggregate amount received under the contract before that date, to the extent that amount was excludable from gross income.

.03 Section 72(e) governs the treatment of amounts received under an annuity contract that are not received as an annuity. Section 72(e)(2) provides in general that such amounts received on or after the annuity starting date are included in gross income, and that amounts received before the annuity starting date are included in gross income to the extent allocable to income on the contract, i.e. on an income-first basis. For purposes of determining the amount taxable under this subsection, § 72(e)(6) defines investment in the contract as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount previously received under the contract, to the extent that amount was excludable from gross income.

.04 Section 1035(a) provides that no gain or loss shall be recognized on certain exchanges of insurance policies. The legislative history of § 1035 states that tax-free exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). Section 1.1035-1 of the Income Tax Regulations provides that "the exchange, without recognition of gain or loss, of an annuity contract for another

annuity contract under § 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract."

.05 In Conway v. Commissioner, 111 T.C. 350 (1998), acq., 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. Such a transaction is sometimes referred to as a "partial exchange." See also Rev. Rul. 2003-76, 2003-2 C.B. 355 (direct transfer of a portion of an annuity contract for a new annuity contract treated as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

.06 Section 7702B(b) defines a qualified long-term care insurance contract as an insurance contract that (a) provides protection only for coverage of qualified long-term care services; (b) does not pay or reimburse expenses incurred for certain services or items reimbursable under Title XVIII of the Social Security Act; (c) is guaranteed renewable; (d) does not provide for a cash surrender value; (e) permits premium refunds or policyholder dividends to be applied only as a reduction in future premiums or an increase in future benefits; and (f) meets the consumer protection requirements of § 7702B(g).

.07 Under § 7702B(a), a qualified long-term care insurance contract is treated as an accident and health insurance contract. Premiums paid under a qualified long-term

care insurance contract are generally treated as payments for insurance for purposes of the deduction under § 213 for expenses paid for medical care, and amounts received as benefits under such a contract generally are treated as amounts received for personal injuries and sickness and as reimbursement for expenses actually incurred for medical care. An employer plan providing coverage under such a contract treats the contract as an accident and health plan with respect to that coverage. The issuer of a qualified long-term care insurance contract treats the contract as a guaranteed renewable contract subject to the rules of § 816(e).

SECTION 3. AMENDMENTS MADE BY THE PPA: DISCUSSION AND APPLICATION

.01 The PPA was enacted on August 17, 2006. Section 844 of the PPA made changes to §§ 72, 1035, and 7702B, and added new reporting requirements for charges or payments for qualified long-term care insurance contracts under combined arrangements.

Section 72

.02 Section 844(a) of the PPA amended § 72(e) by adding a new paragraph, § 72(e)(11). Section 72(e)(11) provides that a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includible in income. The investment in the contract is reduced (but not below zero) by the charge.

.03 The PPA did not otherwise amend the definition of “investment in the contract” in § 72(c)(1) and 72(e)(6). Accordingly, the Treasury Department and the IRS

believe that all premiums paid for a combination contract that is an annuity and also provides long-term care insurance are generally included in investment in the contract under § 72 if (i) the premiums are credited to the contract's cash value (rather than directly to the long-term care insurance contract that is part of or a rider to the contract), and (ii) coverage under the long-term care insurance contract is paid for by charges against the cash value of the contract. Consistently, a waiver of premiums under such a contract, such as on account of disability or because the annuitant has become chronically ill, should be accounted for in the same manner as a waiver of premiums under other contracts for which "investment in the contract" is determined under § 72(c)(1) or 72(e)(6). See, e.g., Estate of Wong Wing Non v. Commissioner, 18 T.C. 205 (1952) (waived premiums not treated as constructively received as disability benefits, and therefore not included as part of premium paid for endowment life insurance policy).

Section 1035

.04 Section 844(b) of the PPA expanded the categories of exchanges that are treated as tax-free under § 1035 to include certain exchanges that involve a qualified long-term care insurance contract. Accordingly, § 1035 now applies to the exchange of a life insurance contract for another life insurance, endowment, annuity, or qualified long-term care insurance contract; an endowment contract for another endowment, annuity, or qualified long-term care insurance contract; an annuity contract for another annuity or qualified long-term care insurance contract; or a qualified long-term care insurance contract for another qualified long-term care insurance contract. The PPA

also amended § 1035(b)(2) and (3) to provide that, for purposes of § 1035, a contract does not fail to be treated as a life insurance contract or an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on the contract.

.05 Just as the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a second annuity contract may be treated as a tax-free exchange under § 1035, the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a qualified long-term care insurance contract may be treated as a tax-free exchange, provided the requirements of § 1035 are otherwise met. See, e.g., Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (setting forth conditions under which such a transfer will be treated as a tax-free exchange under § 1035); but see, Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035).

.06 Although § 7702B(b)(1)(D) and (E) limit the extent to which a qualified long-term care insurance contract may have a cash value or premium refund feature, § 7702B(b)(2)(C) permits the refund of premiums in the event of a complete surrender or cancellation of the contract, provided the amount does not exceed the aggregate premiums paid under the contract. Such a refund is includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums. Moreover, § 1031(d) provides that if property is acquired in an exchange described in

§ 1035(a), then the acquired property's adjusted basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. Accordingly, Treasury and the IRS believe that, under § 1031(d), the adjusted basis of a qualified long-term care insurance contract received in a tax-free exchange under § 1035(a) generally carries over from the life insurance, endowment, annuity, or qualified long-term care insurance contract exchanged.

Section 7702B, Information Reporting, and DAC

.07 Section 844(c) of the PPA amended § 7702B(e) of the Code to provide that, in the case of any long-term care insurance coverage (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract, the portion of the contract providing such coverage is treated as a separate contract. For this purpose, the term "portion" means only the terms and benefits under the life insurance or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care insurance coverage. Prior to this amendment, § 7702B(e) provided a similar rule, but only for coverage provided as part of a life insurance contract.

.08 Section 844(d) of the PPA added § 6050U of the Code, which requires any person who makes a charge against the cash value of an annuity contract (or the cash surrender value of a life insurance contract) that is excluded from gross income under § 72(e)(11) to file an information return setting forth the aggregate amount of such

charges for the year, the amount of the reduction in investment in the contract by reason of such charges, and the name, address, and TIN of the holder of the contract. Statements are required to be furnished to persons with respect to whom information is required.

.09 Section 844(e) of the PPA added § 848(e) of the Code, which treats an annuity or life insurance contract that includes a qualified long-term care insurance contract as a part of or a rider on such a contract as a contract that is subject to a capitalization rate for specified policy acquisition expenses (DAC) equal to 7.7 percent of net premiums.

Effective Date

.10 The amendments made by the PPA are effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009. The amendments relating to tax-free exchanges apply with respect to exchanges occurring after December 31, 2009. The amendment relating to information reporting applies to charges made after December 31, 2009.

SECTION 4. REQUEST FOR COMMENTS

.01 The Treasury Department and Internal Revenue Service request comments to assist in the development of further guidance concerning the taxation of annuity and life insurance contracts with a long-term care insurance feature. For example:

(a) What issues arise when the owner of an annuity contract with a long-term care insurance feature decides to annuitize the contract? Are the policyholder's rights under the long-term care insurance feature typically the same or different before and

after the annuity starting date? How should long-term care insurance charges be accounted for after the annuity starting date? How should the exclusion ratio be determined?

(b) For the purpose of determining whether the long-term care features of an annuity contract qualify as an insurance contract and thus as a qualified long-term care insurance contract, what is the appropriate characterization of long-term care payments that cause a reduction in a contract's cash value? Are there common features or contract designs that would lend themselves to guidance on determining whether enough insurance risk is present for the long-term care features to qualify as an insurance contract?

(c) Is guidance needed on the partial exchange of the right to some or all of the payments under an immediate annuity contract for a qualified long-term care insurance contract? If so, how is such an exchange effected? Under what circumstances should such an exchange be treated as tax-free under § 1035? How should the basis and investment in the contract be apportioned between the qualified long-term care insurance contract received in the exchange and the rights still held in the exchanged annuity?

(d) What changes, if any, are needed to existing guidance (including publications, forms, and instructions) on information reporting and record keeping to assist issuers of life insurance, annuity, or qualified long-term care insurance contracts in meeting their obligations with regard to the amendments made by section 844 of the PPA?

.02 Comments should be submitted in writing on or before November 9, 2011 and should contain a reference to this Notice 2011-68. Comments may be submitted to CC:PA:LPD:PR (Notice 2011-68), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically to *Notice.Comments@irs.counsel.treas.gov*. Please include "Notice 2011-68" in the subject line of any electronic communications.

.03 Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2011-68), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC 20224. All comments will be available for public inspection and copying.

SECTION 5. PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is used in § 1.6662-4(d)(3)(iii) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

DRAFTING INFORMATION

The principal author of this notice is Rebecca L. Baxter of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice contact Ms. Baxter on (202) 622-7117 (not a toll-free call).