

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-125237-00]

RIN 1545-AY60

Debt Instruments with Original Issue Discount; Annuity Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the federal income tax treatment of annuity contracts issued by certain insurance companies. These proposed regulations provide guidance on whether certain annuity contracts are excluded from the definition of a debt instrument under the original issue discount provisions of the Internal Revenue Code. This document also provides a notice of public hearing on the proposed regulations.

DATES: Written or electronically generated comments must be received by April 12, 2001.

Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for May 30, 2001, at 10 a.m. must be submitted by May 9, 2001.

ADDRESSES: Send submission to: CC:M&SP:RU (REG-125237-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be

hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-125237-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). The public hearing will be held in room 4718, 1111 Constitution Ave., NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Patrick E. White, (202) 622-3920; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, contact LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### **Background**

Sections 163(e) and 1271 through 1275 of the Internal Revenue Code (Code) provide rules for the treatment of debt instruments with original issue discount (OID). Section 1275(a)(1)(A) defines the term "debt instrument" to include a bond, debenture, note or certificate or other evidence of indebtedness. Sections 1275(a)(1)(B)(i) and (ii), however, exclude certain annuity contracts from the definition of a debt instrument.

On February 2, 1994, the IRS and Treasury published in the **Federal Register** (59 FR 4799) final regulations concerning a variety of issues under the OID provisions. On January 8, 1998, the IRS and Treasury published in the **Federal Register** (63 FR 1054) final regulations concerning the life annuity exception of section 1275(a)(1)(B)(i). This document contains proposed rules concerning the exception for annuities described in section 1275(a)(1)(B)(ii).

## **Explanation of Provisions**

In general, the OID provisions apply to issuers and holders of debt instruments. The term debt instrument generally means any instrument or contractual arrangement that constitutes indebtedness under general principles of income tax law. See section 1275(a)(1)(A) and §1.1275-1(d).

If a contract is a debt instrument with OID, section 1272 generally requires the holder of the contract to include OID in income currently on a constant yield basis, regardless of the holder's overall method of accounting. By contrast, the holder of an annuity contract to which section 72 applies generally is allowed to defer recognizing economically earned income until distributions are made on the contract.

Section 1275(a)(1)(B) excepts two types of annuity contracts from the definition of a debt instrument. First, section 1275(a)(1)(B)(i) excepts an annuity contract to which section 72 applies if the contract “depends (in whole or in substantial part) on the life expectancy of 1 or more individuals.” Second, section 1275(a)(1)(B)(ii) excepts an annuity contract to which section 72 applies under certain circumstances if the contract “is issued by an insurance company subject to tax under subchapter L (or by an entity described in section 501(c) and exempt from tax under section 501(a) which would be subject to tax under subchapter L were it not so exempt).”

The legislative history of section 1275(a)(1)(B)(ii) is limited. This exception to the OID rules first appeared when the bill emerged from the Conference Committee in 1984. H.R. 4170, 98<sup>th</sup> Cong., 2d Sess. § 41 (1984). At that time, section 1275(a)(1)(B)(ii) applied to certain annuity contracts issued by an insurance company subject to tax under subchapter L. The 1984

Conference Report does not elaborate on the meaning of the phrase “an insurance company subject to tax under subchapter L,” nor does it explain the purpose of the provision. H.R. Conf. Rep. No. 861, 98<sup>th</sup> Cong., 2d Sess. 802-05 (1984), 1984-3 (Vol. 2) C.B. 56-59. In 2000, a technical correction to section 1275(a)(1)(B)(ii) was enacted. The technical correction clarified that section 1275(a)(1)(B)(ii) also applied to annuity contracts issued by “an entity described in section 501(c) and exempt from tax under section 501(a) which would be subject to tax under subchapter L were it not so exempt.” Consolidated Appropriations Act, 2001, Public Law 106-554 (114 Stat. 2763).

In 1998, the IRS and Treasury promulgated §1.1275-1(j), interpreting the life annuity exception of section 1275(a)(1)(B)(i). Commentators had also requested guidance on the scope of the section 1275(a)(1)(B)(ii) exception, particularly with regard to foreign insurers not engaged in a trade or business in the U.S.

The proposed regulations provide that an annuity contract issued by a foreign insurance company is treated as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract. The IRS and Treasury believe that this is the most natural application of the language of section 1275(a)(1)(B)(ii) and is consistent with the use of that phrase elsewhere in the Code and regulations. See, e.g., sections 953(e)(3)(C) and 1297(b)(2)(B); §1.848-2(h). The IRS and Treasury also believe that the exception from the OID rules was intended to preserve a balance between the tax treatment of holders of annuity contracts under section 72 and the tax treatment of issuers of such contracts. This balance does not exist when the annuity contract is issued by a foreign person that is not required to calculate its income with respect to the contract

under subchapter L.

### **Proposed Effective Date**

The proposed regulations are proposed to apply for interest accruals on or after the date that is 30 days after final regulations are published in the **Federal Register** on annuity contracts held on or after that date. The regulations will not apply to an annuity contract that was purchased before January 12, 2001. Special rules are provided for additional investments after January 12, 2001, with respect to an annuity contract held as of that date. This effective date framework is similar to that provided in §1.1275-1(j)(8) with respect to the life annuity exception of section 1275(a)(1)(B)(i).

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies of written comments) that are submitted timely (in the manner described in the “ADDRESSES” portion of

this preamble) to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 30, 2001, beginning at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10<sup>th</sup> Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see “FOR FURTHER INFORMATION CONTACT.”

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 9, 2001. A period of 10 minutes will be allotted to each person making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

The principal author of these regulations is Patrick E. White, Office of the Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

**PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.1271-0 is amended by adding entries for paragraphs (k) through (k)(3) to §1.1275-1 to read as follows:

§1.1271-0 Original issue discount; effective dates; table of contents.

\* \* \* \* \*

§1.1275-1 Definitions.

\* \* \* \* \*

(k) Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L .

(1) Rule.

(2) Examples.

(3) Effective date.

\* \* \* \* \*

Par. 3. Section 1.1275-1 is amended by adding paragraph (k) to read as follows:

§1.1275-1 Definitions.

\* \* \* \* \*

(k) Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L--(1) Rule. For purposes of section 1275(a)(1)(B)(ii), an annuity contract issued by a foreign insurance company is considered as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract.

(2) Examples. The following examples illustrate the rule of paragraph (k)(1) of this section. Each example assumes that the annuity contract is a contract to which section 72 applies and was issued in a transaction where there is no consideration other than cash or another qualifying annuity contract, pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party, or in a transaction involving a qualified pension or employee benefit plan. The examples are as follows:

Example 1. Company X is an insurance company that is organized, licensed and doing business in Country Y. Company X does not have a U.S. trade or business and is not, under section 842, subject to U.S. income tax under subchapter L with respect to income earned on annuity contracts. A, a U.S. taxpayer, purchases an annuity contract from Company X in Country Y. The annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 2. The facts are the same as in Example 1, except that Company X has a U.S. trade or business. A purchased the annuity from Company X's U.S. trade or business. Under section 842(a), Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Under these facts, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 3. The facts are the same as in Example 2, except that there is a tax treaty between Country Y and the United States. Company X is a resident of Country Y for purposes of the U.S.-Country Y tax treaty. Company X's activities in the U.S. do not constitute a permanent establishment under the U.S.-Country Y tax treaty. Because Company X does not have a U.S. permanent establishment, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 4. The facts are the same as in Example 1, except that Company X is a foreign insurance corporation controlled by a U.S. shareholder. Company X does not make an election under section 953(d) to be treated as a domestic corporation. The controlling U.S. shareholder is required under sections 953 and 954 to include income earned on the annuity contract in its taxable income under subpart F. However, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 5. The facts are the same as in Example 4, except that Company X properly elects under section 953(d) to be treated as a domestic corporation. By reason of its election,



Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

(3) Effective date. This paragraph (k) is applicable for interest accruals on or after the

date that is 30 days after final regulations are published in the **Federal Register**. This paragraph (k) does not apply to an annuity contract that was purchased before January 12, 2001. For purposes of this paragraph (k), if any additional investment in a contract purchased before January 12, 2001, is made on or after January 12, 2001, and the additional investment is not required to be made under a binding written contractual obligation that was entered into before that date, then the additional investment is treated as the purchase of a contract after January 12, 2001.

David A. Mader  
Acting Deputy Commissioner of Internal Revenue