



WRNewswire

An AALU Washington Report

Tuesday, 27 February 2014

WRN# 14.02.27

The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody, Linas Sudzius and AALU Staff. The *WRNewswire* provides timely reports and commentary on tax and legal developments important to AALU members, clients and advisors, delivered to your inbox as they happen.

TOPIC: Tax Reform Discussion Draft Contains Provisions Negatively Impacting Life Insurance

CITE: Life Insurance Related Provisions of “The Tax Reform Act of 2014”; House Ways & Means Committee Explanatory Packet; *AALU WRNewswire* WRN#14.02.03 (Feb. 3, 2014); *AALU WR Newswire* WRN #13.11.22 (Nov. 22, 2013).

SUMMARY: House Ways & Means Committee Chairman Dave Camp (R-MI) has released a long-awaited tax reform discussion draft (“**Camp Draft**” or “**Draft**”), which contains provisions that would be detrimental to the sale of life insurance. Specifically, the Camp Draft includes proposals that would: (1) negatively impact corporate-owned life insurance (“**COLI**”); (2) undercut long-standing rules regarding life insurers’ dividends-received deduction (“**DRD**”), (3) impose tax on many nonqualified deferred compensation arrangements; and (4) remove a current exception from transfer-for-value rules and impose taxation in circumstances that include certain indirect acquisitions of life insurance policies in the event of corporate mergers and acquisitions.

The Camp Draft must be taken seriously. This Draft was driven by perhaps the most powerful tax-writer in Congress and contains multiple provisions that would negatively impact life insurance products and companies as well producers and their clients. Accordingly, a meaningful response is warranted. The AALU’s action plan, which includes significant engagement from our membership, is detailed below.

Notwithstanding the context described above, other factors deserve consideration, as well. For example, the Draft is written in statutory text, but has not been introduced as proposed legislation. Moreover, House Republican Leaders have not endorsed the bill, nor have many others on the Ways & Means Committee or across the Republican caucus. Accordingly, no Committee markup is scheduled and—at the moment—such a development would appear unlikely. Finally, Senate Leaders in both parties—as well as new Senate Finance Committee Chairman Ron Wyden (D-OR)—have suggested that tax reform will not be pursued in the Senate in 2014. In sum, the Camp Draft provides AALU members with an opportunity to further educate lawmakers on the utility of life insurance products, but does not signify that the enactment of tax reform is imminent.

ANALYSIS: While more detailed analysis of the Camp Draft will be provided in forthcoming *Washington Report* bulletins and AALU advocacy communications, below is an initial overview of some of the most pertinent provisions of the Draft.

Section 3501 would disallow corporate interest deductions to the extent that corporations own life insurance covering those other than 20% owners. Under the provision, the exception to the pro-rata interest expense disallowance rule set forth in IRC § 264(f) would not apply to officers, directors, or employees, and thus only would apply to 20-percent owners of the business that holds the insurance contract. The provision would be effective for insurance contracts issued after 2014 and any material increase in the death benefit or other material changes to existing contracts being treated as new contracts.

To illustrate the impact of proposed Section 3501, suppose a corporation purchased COLI to secure employee benefits promised to its employees. Subsequently, fifteen years after the purchase of the policy, that corporation borrows money (unrelated to its COLI policy) to help fund an expansion of its business and the hiring of additional employees. Under the proposal, the corporation's deduction for interest paid on this business expansion loan would be disallowed by a ratio that reflects the extent of the unborrowed cash value of the corporation's COLI policy to all assets of the corporation.

The AALU's opposition to this proposal, which has previously been included as a revenue measure in the past four Administration budgets, has been well documented. *See, e.g., AALU WRNewswire #14.02.03* (Feb. 3, 2014). Put simply, the proposal would discourage the use of life insurance by businesses. In effect, it would limit firms' ability to insure key persons, finance and secure health, disability, survivor, and supplemental retirement benefits, and engage in prudent business succession planning. Moreover, the proposal largely ignores the long history of legislative and regulatory initiatives pertaining to COLI, which were designed, successfully, to protect employees and ensure responsible use of the product. Finally, regarding statutory mechanics, the proposal would improperly and broadly extend IRC § 264(f) to corporate

taxpayers based on an unsubstantiated claim regarding inadequate compliance with existing law. In actuality, the Code Section was expressly written in 1997 to apply *only* to mortgage intermediaries Fannie Mae and Freddie Mac for purposes of preventing those institutions from insuring mortgagees not under their employment. Thus, the broad application of § 264(f) was not contemplated at the time and would not be appropriate now.

While, on its face, proposed Section 3501 would affect only the COLI marketplace, because the proposal largely ignores the legislative and regulatory history of COLI and the public policy benefits of life insurance, the justifications for it—however misguided—could be applied to future proposals affecting individual policies.

Section 3801 would make a significant negative change to the current tax treatment of deferred compensation arrangements by imposing tax on employees' nonqualified deferred compensation as soon as there is no substantial risk of forfeiture of that compensation (*i.e.*, receipt of the compensation is not subject to future performance of services). The provision would be effective for amounts attributable to services performed after 2014. For amounts attributable to services performed through 2014, the current law rules would continue to apply to existing nonqualified deferred compensation arrangements until the last tax year beginning before 2023, when such arrangements would become subject to the provision.

Section 3506 would undercut longstanding rules regarding life insurers' dividends received deduction that are designed to prevent double taxation of corporate earnings. Under the provision, the portion of dividends and tax-exempt interest received that is set aside for obligations to policyholders would be determined separately for the company's general account (which supports non-variable insurance products) and for each separate account (which supports non-variable life insurance and annuity contracts). In addition, the formula for determining this portion would be modified so that it compares mean reserves of each account (rather than computing the respective shares of net investment income that belong to the company and to policyholders). The provision would be effective for tax years beginning after 2014.

Section 3515 would remove a current exception from transfer-for-value rules and impose taxation in circumstances that include certain indirect acquisitions of life insurance policies in the event of corporate mergers and acquisitions. Under the provision, the exception under current law for carryover basis transfers and transfers to the person whose life is insured (or to a partner of the insured, or a partnership or corporation in which the insured is a partner or shareholder) would not apply if the acquirer of the life insurance contract has no relationship with the insured apart from the acquirer's interest in the contract (*i.e.*, the acquirer must include the amount of the payment on the death of the insured, reduced by the acquirer's basis in the contract). The provision would be effective for transfers after 2014.

Regarding proposals similar to proposed Section 3515, the AALU and the broader life insurance industry have pointed out the need for legislative drafting changes to avoid inappropriate and harmful taxation in circumstances that include certain indirect acquisitions of life insurance policies in the event of corporate mergers and acquisitions. See *AALU WRNewswire* WRN #13.11.22 (Nov. 22, 2013).

* * * * *

The above proposals, if enacted, would bring about considerable adverse consequences for the life insurance industry and therefore justify immediate engagement. However, as a general matter, it is important to keep in mind the context in which the Camp Draft has been released. As is mentioned above, the Draft has not been assigned a bill number and there is currently no indication that the Draft will be marked up and voted on by the Ways & Means Committee. This means that while the document has been written in statutory text, it is perhaps more appropriately viewed as establishing a foundation for continued policy discussions rather than a fast moving legislative vehicle. As such, lawmakers will be seeking feedback on the Draft, much like the Committee did in 2013 as part of its Tax Reform Working Groups exercise.

Furthermore, House Republican Leaders have not endorsed the substance of the Draft. House Speaker John Boehner (R-OH) has characterized the release of the Draft merely as an opportunity for a “public conversation about the issue of tax reform.” Russell Berman & Bernie Becker, *Boehner Scoffs at Tax Reform Vote*, THE HILL (Feb. 26, 2014), <http://thehill.com/homenews/house/199300-boehner-lowers-expectations-on-tax-reform>.

It is unclear how assertive Chairman Camp and other supporters of the Draft will be in advocating for additional action toward reform—but, there is unquestionably some degree of dissonance amongst the Republican caucus regarding the substance and timing of reform as well as the associated political costs and benefits and, as a result, it appears that House Leaders are at the moment unlikely to assist in any effort to advance the Draft.

Finally, should Chairman Camp and the Republican caucus somehow agree on a path forward in the House, Senate Leaders have virtually foreclosed the possibility of tax reform consideration in the Senate in 2014, citing fundamental differences in the objectives behind reform as a threshold barrier. In addition, Chairman Wyden has publicly underscored the importance of focusing the Committee’s attention on addressing the 55 expired business tax provisions collectively known as “tax extenders.” The implication behind this strategy is that comprehensive tax reform is not Chairman Wyden’s top priority in the immediate future.

Taken together, the above dynamics reflect that while any proposal that would be harmful to AALU members and the sale and use of life insurance products presents a concern and an

opportunity for direct engagement, there is little chance of the above mentioned proposals being enacted into law in the foreseeable future.

NEXT STEPS: The AALU is employing a multi-faceted action plan in response to the life insurance-related provisions of the Camp Draft. Below is a summary of its key components.

Communications & Analysis. This is one of several upcoming communications on the Camp Draft. Next week, the AALU will publish a follow-up *AALU WRNewswire* bulletin surveying the entirety of the Draft. In addition, the [AALU monthly advocacy teleconference on March 4th](#) will be exclusively devoted to a discussion regarding the Draft and the AALU's strategic response to the Draft's life insurance-related provisions. During the week of March 3rd, the Obama Administration will release its Fiscal Year 2015 budget proposal—which is likely to contain several of the revenue measures offered in previous years, including the COLI pro-rata interest disallowance proposal—and may mirror the revenue provisions of the Camp Draft to some extent. The AALU will publish an *AALU WRMarketplace* bulletin that summarizes the Administration's budget and provides additional technical analysis of certain aspects of the Camp Draft.

Volunteer Engagement. There will be ample opportunity for AALU members to directly engage with lawmakers—both inside and outside of Washington—and this engagement is an essential component of our action plan. AALU Ambassadors who maintain relationships with Ways & Means Committee members and House Leaders are currently in the process of connecting with these congressional offices to discuss the Draft and the AALU's concerns. Moreover, the entire AALU membership will have two distinct opportunities to connect with members of Congress in the near future. The first will be via a pending advocacy action alert, which you can expect to receive in your inbox next week. The second will be during the 2014 Capitol Hill Club Day at the [AALU Annual Meeting](#) on Tuesday, May 6th. In addition, during the lead-up to the Annual Meeting, AALU members are encouraged to work with the AALU staff to schedule in-district meetings with elected officials. Finally, AALU members are asked to share your reactions to any and all details of the Camp Draft by sending your thoughts to taxreform@aalu.org. The AALU's legislative affairs team will monitor the account and will seek to engage those who have contributed their ideas as needed. In the days ahead, the AALU will be establishing a voice mailbox for the same purpose in an effort to facilitate the free flow of input from the membership.

Industry Collaboration. The AALU will be working closely with its industry partners in the days ahead to fashion an industry-wide response. This may include the submission of written comments on behalf of the industry's "Secure Family" Coalition (for more information, visit www.securefamily.org) and/or heightened public affairs activity. Expect to receive additional information on the industry's collective action plan in the days ahead.

***WRNewswire # 14.02.27* was written by AALU Staff.**

DISCLAIMER

In order to comply with requirements imposed by the IRS which may apply to the Washington Report as distributed or as re-circulated by our members, please be advised of the following:

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this Washington Report is also considered to be a “marketed opinion” within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.