

Premier analysis of federal legislative and regulatory developments for the nation's 2,000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel

Buchanan Ingersoll & Rooney PC *PricewaterhouseCoopers*
Gerald H. Sherman William Archer
Stuart M. Lewis Donald Carlson
Deborah M. Beers

Keith A. Mong *Ricchetti, Inc.*
Steve Ricchetti
Jeff Ricchetti

Federal Policy Group *Arnold & Porter LLP*
Ken Kies Martha L. Cochran
Matthew Dolan David F. Freeman, Jr.

AALU

David J. Stertz, *Chief Executive Officer*
Marc R. Cadin, *Senior VP of Legislative Affairs*
Chris Morton, *Vice President of Legislative Affairs*
Tom Korb, *Vice President of Policy & Public Affairs*
Sarah Spear, *Director of Policy & Public Affairs*
Anthony Raglani, *Asst. Dir. of Policy & Public Affairs*

101 Constitution Avenue NW, Suite 703 East
Washington, DC 20001
Toll Free: 1-888-275-0092 Fax: 202-742-4479
www.aalu.org

AALU Bulletin No: 10-77

July 27, 2010

Subject: **Sens. Baucus and Reid Offer Substitute Amendment to H.R. 5297 (the “Small Business Jobs Act of 2010”) With Provision Permitting Partial Annuitization of Certain Annuity, Endowment and Life Insurance Contracts**

Major References: [*Amendment in the Nature of a Substitute to H.R. 5297; “Summary of the Substitute Amendment to the Small Business Jobs Act.” \(H.R. 5297\) \(7/21/2010\)*](#)

Prior AALU Washington Reports: 10-75; 10-15; 09-118; 03-67; 03-110; 08-09

MDRT Information Retrieval Index Nos.: 7400.00

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

We recently reported (see our Bulletin No. 10-75) on a “motion to recommit” H.R. 5297 (the “Small Business Jobs Act”) offered by Sens. Kyl (R-AZ) and Lincoln (D-AK). That motion would have contained instructions regarding estate tax provisions that essentially would have incrementally raised the exemption from the current \$3.5 million to \$5 million and would have decreased the maximum rate of tax from the current 45% to 35%.

More recently, Sens. Baucus (D-MT), Senate Finance Committee Chairman, and Reid (D-NV), Senate Majority Leader, have offered an amendment in the form of a substitute to H.R. 5297. While silent on the estate tax, the amendment would allow the partial annuitization of payments received under certain annuity, endowment and life insurance contracts. The provisions would apply to amounts received under such contracts after December 31, 2010.

The text of the provision's summary reads as follows:

“Permit Partial Annuitization of a Nonqualified Annuity Contract. The substitute would allow holders of nonqualified annuities (that is, annuity contracts held outside of a tax-qualified retirement plan or IRA) to elect to receive a portion of the contract in the form of a stream of annuity contracts, leaving the remainder of the contract to accumulate income on a tax-deferred basis. This provision is estimated to raise \$956 million over ten years.”

While the summary refers only to nonqualified annuity contracts, the accompanying legislative language includes “any amount is received as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity, endowment, or life insurance contract.”

Under current law, a taxpayer may exchange a portion of an existing annuity contract for a second annuity contract and, under certain circumstances, annuitize one of the contracts involved in the exchange. (See our Bulletins Nos. 03-67, 03-110, and 08-09) An exclusion ratio then applies to determine the extent to which amounts received as an annuity under the annuitized contracts are included in gross income. Current law does not, however, address the treatment of a transaction in which the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis. According to a proposal included as part of the President’s FY 2011 Budget, it is appropriate, “that these transactions be treated consistently.” (See our Bulletin No. 10-15.)

As under the President’s Budget Proposal, the Baucus-Reid Amendment would apply an exclusion ratio to each amount received as an annuity with regard to a portion of a nonqualified deferred annuity, endowment or life insurance contract that is partially annuitized. This treatment would be available only if: the stream of annuity payments is either for at least ten years or for the life of one or more individuals. The exclusion ratio must be computed based on the expected return and investment in the contract with regard to the portion of the contract that is annuitized.

Although it is unclear how such a partial annuitization might be taxed for income tax purposes (and further clarity was not provided by the Baucus/Reid materials), one scenario may be illustrated by the following which, in an effort by us to enhance clarification, simply reflects our conjecture, even if not informed by an authoritative source:

Example. Annuitant, aged 60, purchased a deferred annuity contract providing for payments of approximately \$293 per month (\$3,516 per year) for life for a consideration of \$12,730. Assuming a “return multiple” of 16 (Annuitant’s life expectancy at age 70), the expected return under this contract is \$56,256, the exclusion ratio to be used by Annuitant is $\$12,730/\$56,256$ or 22.6% (i.e., 22.63 rounded to the nearest tenth). Thus, beginning in year 10, at age 70, Annuitant would be entitled to exclude approximately \$795 of each \$3,516 yearly payment from income as a return of basis.

If, in year 5, when Annuitant is aged 65 and the amount invested in the contract has grown to approximately \$19,320, he decides to annuitize one half of the contract for monthly payments of approximately \$85 per month (\$1,020 per year) for life. If Annuitant’s original investment in the contract (\$12,730) is prorated, his investment in 1/2 of the contract is \$6,365. Assuming a “return multiple at age 65 of 20, and, thus, an expected return in the annuitized portion of the contract of \$20,400, the exclusion ratio to be used by Annuitant is $\$6,365/\$20,400$, or 31.2%. Thus, beginning in year 5, at age 65, Annuitant would be entitled to exclude approximately \$318 of each \$1,020 yearly payment from the annuitized portion of the contract as a return of basis. Presumably,

when the other 1/2 of the contract is annuitized at age 70, Annuitant may apply the original exclusion ratio of 22.6% to those payments.

Taxpayers who elect the partial annuitization option would be given credit for return of basis, and may view this option as a substitute for withdrawals from IRA accounts prior to the account holder's required beginning date, assuming that no penalty taxes apply under section 72(q).

Any AALU member who wishes to obtain a copy of the Substitute Amendment to H.R. 5297 or the Summary may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org, enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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 mission of AALU is to promote, preserve and protect advanced life insurance planning for the benefit of our members, their clients, the industry and the general public.

For more information about how AALU's advocacy efforts help protect your business and the advanced life insurance marketplace, visit our website at www.aalu.org, or call toll free 1-(888)-275-0092.