Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Gaines	Analyst:	Scott McFarlane	Bill Number:	SB 1552
Related Bills:	See Legislative History	Telephone:	845-6075	Introduced Date: / Amended Date:	February 24, 2012 / April 17, 2012
		Attorney:	Patrick Kusiak	Sponsor:	

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

SUMMARY

This bill would modify California law to generally conform to the federal tax treatment of annuity and life insurance contracts that have a long-term care insurance feature.

RECOMMENDATION

No position.

Summary of Amendments

As introduced on February 24, 2012, this bill would modify California law to partially conform to the changes made by section 844 of the Pension Protection Act of 2006 (PPA) to the federal tax treatment of annuity and life insurance contracts that have a long-term care insurance feature; as amended on April 17, 2012, this bill would modify California law to fully conform to the applicable tax changes made by PPA section 844. This is the department's first analysis of the bill.

REASON FOR THE BILL

It appears that the purpose of the bill is to conform to the PPA changes that make it easier for individuals to purchase long-term care insurance as part of an annuity or life insurance contract.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would be specifically operative for taxable years beginning on or after January 1, 2012.

ANALYSIS

INTRODUCTION

Prior to the PPA, California law generally conformed to the federal tax treatment of long-term care insurance; however, the PPA made substantial changes to such treatment, specifically to annuity and life insurance contracts that have a long-term care insurance feature, and California law does not conform to those changes. Thus, the following "California Law" section explains current state law (and pre-PPA federal law), and the "Federal Law" section explains the changes that were made in 2006 by the PPA.

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STATE/FEDERAL LAW

California Law (and Federal Law Prior to the PPA)

Annuity Contracts

General Tax Treatment

Earnings and gains on amounts invested in a deferred annuity contract held by an individual are not subject to tax during the deferral period. When payout commences, the tax treatment of amounts distributed depends on whether the amount is received as an annuity (generally, as periodic payments under contract terms), or not.

Amounts Received as an Annuity

For amounts received as an annuity by an individual, an "exclusion ratio" is provided for determining the taxable portion of each payment. The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract; that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Amounts Not Received as an Annuity

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date. Amounts not received as an annuity are included in income to the extent allocable to income on the contract if received before the annuity starting date; specifically, as income first. In general, loans under the annuity contract, partial withdrawals and partial surrenders are treated as amounts not received as an annuity and are subject to tax as income first. Exceptions are provided in some circumstances, such as for certain grandfathered contracts, certain life insurance and endowment contracts (other than modified endowment contracts), and contracts under qualified plans. Under these exceptions, the amount received is included in income, but only to the extent it exceeds the investment in the contract; that is, as basis recovery first.

Life Insurance Contracts

General Tax Treatment

Qualified life insurance contracts receive favorable tax treatment. In general, earnings (inside buildup) of a life insurance contract held by an individual are not subject to tax. This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract. Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income.

Qualification Tests

In the early 1980's, certain life insurance contracts allowed policyholders to invest a substantial cash fund without a related increase in the amount of pure insurance protection offered by the contract without losing the favorable tax treatment of a life insurance contract. This was changed in 1984 when Congress enacted new rules to limit the use of life insurance as primarily a tax-sheltered investment.[1] These rules provide tests that a contract must meet in order to receive the favorable tax treatment of life insurance; specifically, in order to be treated as a qualified life insurance contract for tax purposes, a contract must meet the cash accumulation test or the guideline-premium test and the corridor test.

The cash accumulation test limits the contract's cash surrender value. A contract meets the cash accumulation test if the cash surrender value of the contract does not exceed the net single premium that would have to be paid at such time to fund future benefits.[2]

The guideline-premium test limits cumulative premiums. A contract meets the guideline-premium test if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation as of that time. The guideline premium limitation as of any date is the greater of the guideline single premium, or the sum of the guideline level premiums to that date. The guideline single premium is the premium that would be required on the date the contract is issued to fund the future benefits using an interest rate of no less than six percent. The guideline level premium is the level annual amount, generally calculated as guideline level premium, but payable over a period not ending before the insured attains age 95 and using an interest rate of no less than four percent.

A contract meets the corridor test if the death benefit is never less than a specified percentage[3] of the cash surrender value.

If a contract fails the tests, then only the excess of the death benefit over the net cash value is excludable from income. In addition, the income on the contract during any given year is treated as ordinary income, and any accumulated income from prior taxable years will be treated as ordinary income in the year the contract fails to qualify under the tests.

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[1] The new rules, enacted by the Tax Reform Act of 1984 (Public Law 98-369), were generally effective for all life insurance contracts issued after 1984 in taxable years ending after 1984. Previously, temporary rules that were similar were imposed on flexible premium life insurance contracts (sometimes referred to as "universal life insurance" or "adjustable life insurance") by the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248).

[2] The term "future benefits" means death benefits and endowment benefits. The death benefit is the amount payable by reason of the death of the insured. A contract of endowment insurance is a contract with an insurance company that depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during the life of the insured.

[3] The "applicable percentages" under IRC section 7702(d) that range from 250 percent to 100 percent, decreasing as the age of the insured increases.

Modified Endowment Contracts

The qualification tests described above did not place strict enough restrictions on single-premium life insurance contracts, which continued to be purchased primarily as an investment rather than as life insurance because of three primary benefits:

1. Undistributed investment income earned on premiums which qualified as life insurance was not currently taxed;

2. Death benefits paid under a life insurance contract were excluded from gross income; and

3. Amounts received under a life insurance contract before the death of the insured were not included in income to the extent that the amount received was less than the investment.

As a result, Congress enacted a new classification of life insurance contracts in 1988 called "modified endowment contracts." A modified endowment contract is a life insurance contract that does not meet the "seven-pay" test. The "seven-pay" test has nothing to do with the actual number of premium payments; instead, it's a limitation on the total amount that can be paid into a policy during the first seven years of its existence.

Distributions from a modified endowment contract are generally treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional tax[4] is generally imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

Long-Term Care Insurance Contracts

In General

A qualified long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services, and that meets additional requirements. The contract is not permitted to provide for a cash surrender value or other money that can paid, assigned or pledged as collateral for a loan, or borrowed (and premium refunds are to be applied as a reduction in future premiums or to increase future benefits). Per-diem-type and reimbursement-type contracts are permitted.

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal-care services that are required by a chronically-ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

A chronically-ill individual is generally one who has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity (or meeting other definitional requirements).

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[4] R&TC section 17085 and IRC section 72.

General Tax Treatment

Qualified long-term care insurance contracts receive favorable tax treatment. A qualified long-term care insurance contract is treated as an accident and health insurance contract. Amounts received under the contract generally are excludable from income as amounts received for personal injuries or sickness. The excludable amount is capped at $300 per day (for 2011), as indexed, on per-diem contracts only. If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of costs in excess of the dollar cap that are incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to the rules relating to return of basis.

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan (benefits under which generally are excludable from the recipient's income).

Premiums paid for a qualified long-term care insurance contract are deductible as medical expenses, subject to a dollar cap on the deductible amount of the premium per year based on the insured person's age at the end of the taxable year. Medical expenses generally are allowed as a deduction only to the extent they exceed 7.5 percent of adjusted gross income.

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the deduction for medical expenses. Amounts received under a qualified long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per-diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

Long-Term Care Riders on Life Insurance Contracts

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts apply as if the portion of the contract providing such coverage were a separate contract. The term "portion" means only the terms and benefits that are in addition to the terms and benefits under the life insurance contract, without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value.

The guideline premium limitation is increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, the imposition of which reduces premiums paid for the contract. Thus, a policyholder can pre-fund to a greater degree a life insurance policy with a long-term care rider without causing the policy to lose its tax-favored treatment as life insurance.

A medical-expense deduction is generally not allowed for charges against the life insurance contract's cash surrender value, unless such charges are includible in income because the life insurance contract is treated as a modified endowment contract.

Exchanges of Insurance Contracts

Certain insurance contracts may be exchanged without recognition of gain or loss. No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract, (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract, or (3) an annuity contract for an annuity contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged. Tax-free exchanges of long-term care insurance contracts are not permitted.

Conformity to Federal Law

California law generally conforms to the federal treatment of annuity and life insurance contracts with a long-term care feature that was in effect prior to the enactment of the PPA. The Conformity Bill of 2010[5] changed California's specified date of conformity to the Internal Revenue Code from January 1, 2005, to January 1, 2009, but also modified California law to specifically not conform to the changes made by the PPA to the tax treatment of annuity and life insurance contracts with a long-term care feature.

Federal Law

The following modifications to the federal tax treatment of annuity and life insurance contracts with a long-term care insurance feature were made in 2006 by section 844 of the PPA; these modifications are effective generally for contracts issued after December 31, 1996, apply to taxable years beginning after December 31, 2009, and are the current differences between state and federal law to the extent that they apply for California income and franchise tax purposes:

1. Exclusion from Income for Charge Against Cash Value or Cash Surrender Value

Any 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 includable in income. The investment in the contract is reduced (but not below zero) by the charge.

2. Like-Kind Exchange Treatment

The rules for tax-free exchanges of certain insurance contracts are expanded by providing that no gain or loss is recognized on the exchange of a life insurance contract, an endowment contract, an annuity contract, or a qualified long-term care insurance contract for a qualified long-term care insurance contract.

[5] SB 401 (Wolk, Ch. 14, Stats. 2010).

3. Long-Term Care Insurance Riders on Annuity and Life Insurance Contracts

A contract does not fail to be treated as an annuity contract, or as a life insurance contract, solely because a qualified long-term care insurance contract is a part of or a rider on such contract, for purposes of the rules for tax-free exchanges of certain insurance contracts. Except as otherwise provided in regulations, in the case of a long-term care insurance contract (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 long-term care insurance coverage is treated as a separate contract.

The term "portion" means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the life insurance contract's death benefit or cash surrender value or in the annuity contract's cash value.

4. No Deduction for Medical Expenses

The medical-expense deduction is not allowed for any payment made for coverage under a qualified long-term care insurance contract if the payment is made as a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract.

5. Certain Retirement Arrangements Not Treated as Annuity Contracts

Certain retirement arrangements[6] are not treated as annuity contracts for purposes of long-term care coverage. These are generally arrangements that are funded with pre-tax sources, but also include arrangements funded with post-tax sources, such as Roth IRAs.

6. Guideline Premium Limitation

The guideline premium limitation is not directly increased by charges against a life insurance contract's cash surrender value for coverage under the qualified long-term care insurance portion of the contract. Rather, because such charges are not included in the holder's income by reason of new IRC section 72(e)(11),[7] the charges reduce premiums paid for purposes of the guideline premium limitation. The amount by which premiums paid are reduced under this rule is intended to be the sum of any charges (but not premium payments) against the life insurance contract's cash surrender value for long-

[6] Specifically, a trust described in IRC section 401(a) that is exempt from tax under IRC section 501(a) (e.g., a 401(k) plan), a contract that is: (1) purchased by a trust described in IRC section 401(a) that is exempt from tax under IRC section 501(a), (2) described in IRC section 403(b), (4) provided for employees of a life insurance company under a plan described in IRC section 818(a)(3), or (5) an individual retirement account or an individual retirement annuity, or a contract purchased by an employer for the benefit of the employee (or the employee's spouse).

[7] Because such charges are not included in the holder's income under new IRC section 72(e)(11), the effect would be to increase the guideline premium limitation under prior-law IRC section 7702B(e)(2)(A) by the amount of the charges and simultaneously to reduce it by the same charges under IRC section 7702B(e)(2)(B). Such charges that are not included in income serve to reduce premiums paid under IRC section 7702(f)(1), and therefore would cancel each other out under IRC section 7702B(e)(2)(A) and (B).

term care coverage made to that date under the contract. (The so-called "pay-as-you-go" rule that was in effect prior to the PPA increased the guideline premium limitation by this same amount, reduced by charges the imposition of which reduced the premiums paid under the contract. Thus, this provision of the PPA recreates the result of the "pay-as-you-go" rule as a reduction in premiums paid rather than as an increase in the guideline premium limitation.)

7. Capitalization of Policy Acquisition Expenses of Insurance Companies

The application of the rules relating to capitalization of policy acquisition expenses of insurance companies is modified. In the case of an annuity or life insurance contract that includes a qualified long-term care insurance contract as a part of or rider on the annuity or life insurance contract, the specified policy acquisition expenses that must be capitalized is determined using 7.7 percent of the net premiums for the taxable year on such contracts.

8. Information Reporting

Information reporting is required by 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 excludible from gross income under the provision. The information required to be reported includes the amount of the aggregate of such charges against each such contract for the calendar year, the amount of the reduction in the investment in the contract by reason of the charges, and the name, address, and taxpayer identification number of the holder of the contract. A statement is required to be furnished to each individual identified in the information report. Penalties apply for failure to file the information report or furnish the statement required under the provision.

THIS BILL

This bill would modify California tax law to generally conform to the applicable federal tax changes made by the PPA to the treatment of annuity and life insurance contracts with a long-term care feature; specifically, California law would conform to the federal:

1. Exclusion from income for charges against the cash value or cash surrender value;
2. Like-kind exchange treatment;
3. Treatment of long-term care insurance riders on annuity and life insurance contracts;
4. Denial of the deduction for medical expenses;
5. Rule that provides that certain retirement-related arrangements are not treated as annuities for purposes of long-term care; and,
6. Guideline premium limitation.

The PPA modifications to the rules relating to capitalization of policy acquisition expenses of insurance companies that offer long-term care insurance are not applicable under California income or franchise tax law because insurance companies are not subject to California income or franchise tax; instead, insurance companies pay the gross premiums tax that is administered by the Board of Equalization.

And, while this bill would not conform to the PPA information reporting requirement that applies to 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 excludible from gross income under provisions of the PPA, it would allow California to request a copy of the information required to be reported for federal purposes.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

SB 401 (Wolk, Ch. 14, Stats. 2010) changed the Revenue and Taxation Code's general "specified date" of conformity to the Internal Revenue Code from January 1, 2005, to January 1, 2009, but also modified California law to specifically not conform to the applicable PPA section 844 changes to the treatment of annuity and life insurance contracts with a long-term care feature.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. A review of the laws of these states found that they generally conform to the federal treatment of annuity and life insurance contracts with a long-term care insurance feature.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 1552 As Introduced on February 24, 2012, and as Amended on April 17, 2012 For Taxable Years Beginning On or After January 1, 2012 Assumed Enactment After June 30, 2012 ($ in Millions)		
2012-13	2013-14	2014-15
-$30	-$30	-$38

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None on file.

Opposition: None on file.

ARGUMENTS

Proponents: Some people may argue that this bill would increase the number of individuals who would be able to purchase long-term care insurance and would ease reporting compliance by eliminating the current differences between federal and state law.

Opponents: Some people may argue that with the state's current fiscal crisis, additional tax expenditures should be avoided or offset by additional revenues.

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