The Protecting Proper Life Insurance from Abuse Act: Section by Section Summary

Section 1:

Section 1 creates new Section 7702C of the Internal Revenue Code ("IRC" or the "code"), which defines a Private Placement Contract (PPC) as either a life insurance or annuity contract purchased by accredited investors or qualified purchasers, as defined in securities law. A contract can get out of being treated as a PPC if the segregated asset account held at the issuing insurance company that supports the contract supports at least 25 other PPCs, the value of the contract is supported by each asset in the account, and the assets support the account on a pro rata basis.

Special rules apply to define foreign-issued PPCs held directly or indirectly by a U.S. person. Under these rules, a contract can be a PPC if it would be treated as a life insurance or annuity contract in the U.S. or is a life insurance or annuity contract under local law. Foreign-issued annuity contracts will be PPC's if distributions from the account reflect investment returns and the market value of at least one asset. In the case of a foreign-issued life insurance contract, the contract will be a PPC if the death benefit amount is adjusted on the basis of investment return and the market value of at least one asset supporting the contract.

PPCs are not treated as life insurance or annuity contracts for purposes of the code: there will be no tax-free inside build up and no tax-free life insurance death benefits. For contract holders, the earnings and losses of the investment assets supporting the PPC are treated as accruing directly to the PPC holder. This means that earnings and losses on these investment assets will be taxed currently to the contract holder, and basis in the contract is adjusted accordingly. Upon the death of the insured, the beneficiary under the contract will be liable for taxes due on the amount of the death benefit that exceeds the basis (amounts paid into the contract plus amounts taken into income over the lifespan of the contract).

Aggregation rules apply such that all PPCs held directly or indirectly by a holder will be treated as a single PPC. Thus, PPC status can not be avoided by firms entering into 25 separate contracts with the same holder. The draft also provides that if a contract becomes a PPC all prior earnings are taxed in the year in which the contract becomes a PPC. The proposal also provides that once a contract is a PPC it will always be a PPC, so there is no way to amend the contract and cause it to be treated as a traditional life insurance or annuity contract.

Insurance companies will not be permitted to deduct reserves relating to the PPC since a PPC is not a life insurance or annuity contract. Rather, the income earned on the PPC will be taken into account under an accrual method of accounting. Further, life insurance companies will not be able to include the reserves in the calculation of determining whether they meet the statutory definition of life insurance company under the code.

The Internal Revenue Service (IRS) is granted broad regulatory authority to implement this proposal including rules that prevent avoidance through the use of related or accommodation parties, prevent

taking items into account more than once, and rules providing whether one or more person is an indirect holder of a PPC.

The proposal is effective upon the date of enactment, applying to existing contracts as well as new contracts. For existing contracts, all prior earnings must be taken into account. The proposal provides transition relief under which an existing contract has 180 days to convert to a non-PPC or liquidate the policy.

Section 2:

Section 2 imposes reporting requirements on insurance companies that issue or reinsure PPCs. Reporting must be done within 30 days of issuance of a PPC. Failure to make such a filing results in a $1 million penalty and an additional $1 million will be applied for each 30-day period after the initial period for which reporting is not done. Additionally, if an insurer fails to properly report, the state or local regulator with jurisdiction over the insurance company and the Securities and Exchange Commission must be notified. After the initial report, the insurer is required to report information about ownership and basis annually to the IRS and the contract holder.

For contracts issued outside the U.S., the draft proposes that the premium excise tax of section 4371 remain active even though the contracts are no longer treated as life insurance or annuity contracts for the rest of the code. The proposal also provides rules that require reporting under the Foreign Account Tax Compliance Act to foreign issued contracts.