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VIA ELECTRONIC MAIL

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Office of Tax Policy
Department of Treasury
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Re: Transition Relief for New Requirements on 2013 Form 1099-R

Dear Lori:

We are writing on behalf of the Committee of Annuity Insurers and the American Council of Life Insurers to request transition relief with respect to a new information reporting requirement under IRS Form 1099-R for the 2013 tax year.¹ The new requirement relates to distributions from annuity and life insurance contracts that may be subject to the tax on net investment income (the "NII Tax") imposed by section 1411 of the Internal Revenue Code.²

In February of this year, the Internal Revenue Service issued the 2013 instructions for IRS Form 1099-R. The instructions described a new distribution code (Code "D") that insurance companies must include in Box 7 of the form "to identify nonqualified annuity payments that may be subject to tax under section 1411." When life insurers reviewed these instructions, they discovered a significant problem with the instructions relating to Code D. The instructions stated that Code D could not be used in conjunction with any other distribution code. The inability to combine Code D with other distribution codes was very confusing and problematic. For example, the instructions also required (as they have for years) Code 1 to be included in Box 7 to

¹ The Committee of Annuity Insurers (the "Committee") is a coalition of life insurance companies formed in 1981 to participate in the development of federal policy with respect to annuities. Its current 28 member companies represent approximately 80% of the annuity business in the U.S. The American Council of Life Insurers (the "ACLI") represents more than 300 life insurers and fraternal benefit societies. Its membership represents 90% of the assets and premiums of the U.S. life insurance and annuity industry.

² Congress added section 1411 to the Internal Revenue Code as part of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 § 1402(a)(1). The new provision is effective for taxable years beginning after December 31, 2012. The Treasury Department has released proposed regulations under section 1411. See 77 Fed. Reg. 72,618 (Dec. 5, 2012).

indicate that a distribution from a non-qualified annuity is likely subject to a 10% penalty tax on “early” distributions. If using Code D meant that Code 1 could not be used, the Form 1099-R would lack critical information about the penalty tax. The problem was compounded by the fact that Code D apparently applies to every taxable distribution from a non-qualified annuity contract because every such distribution “may” be subject to the NII Tax depending on the recipient’s adjusted gross income (which the life insurer will not know). If Code D could not be combined with any other distribution code but is always required in connection with any distribution from a non-qualified annuity contract, then other distribution codes – particularly those relating to the penalty tax – would always be precluded on any Form 1099-R relating to such a contract.³

As you know, on March 27th, we sent a letter to the IRS asking for (1) certain clarifications to the Form 1099-R instructions as they relate to the new reporting requirement, in particular Code D, and (2) transition relief with respect to the new requirement. We were very pleased and appreciative that the IRS addressed our concern with the Code D instructions when it released a revised version of the instructions on April 12th. Specifically, the revised instructions provide that a Code D can be combined with the necessary numeric codes in Box 7. The IRS has not, however, addressed the issue of transition relief. As explained below, such relief is urgently needed and fully warranted.

Why Transition Relief is Needed

As noted above, it appears that every taxable distribution from a non-qualified annuity requires the insurer not only to issue a Form 1099-R, but to also enter Code D in Box 7.⁴ In order to comply with this new requirement, life insurance companies will need to make changes to their information reporting systems and procedures. These systems are, of course, almost completely automated and linked to, or part of, the computer based systems companies use to administer various aspects of their annuity and life insurance contracts. For example, when an individual requests a withdrawal from his or her non-qualified annuity, the administrative system will modify the data stored in the system for that annuity to reflect the withdrawal, identify the taxable amount, if any, associated with the withdrawal, determine whether the withdrawal is subject to the 10% penalty tax imposed on certain distributions by section 72(q) and flag other information needed for the company’s accounting processes and information reporting obligations. Although administrative systems vary by company, there are a number of reasons why implementing the new reporting requirement for the 2013 tax year will present difficulties in light of current information reporting systems.

Periodic data feeds. A number of systems currently in use will periodically, *e.g.*, daily or monthly, transfer the information that will need to be reported on the Form 1099-R, including the appropriate distribution codes, to the portion of the system that will generate the Forms 1099-R

³ The preamble to the proposed NII Tax regulations apparently views all taxable non-qualified annuity distributions as gross income from annuities within the meaning of section 1411.

⁴ In the case of a life insurance contract, every taxable distribution also requires a Form 1099-R to be issued, but it is expected that few of these distributions will require a Code D.

at the end of the year.⁵ For companies with these types of systems and procedures, any data feeds that occurred before the original 2013 Form 1099-R instructions were made available in February will lack a Code D, because insurers did not know until then that such a code would be required for annuity distributions. Moreover, because the original 2013 Form 1099-R instructions prohibited combining a Code D with commonly used numeric codes, insurers recognized that the instructions would need to be modified in some manner. As a result, they were understandably reluctant to begin reprogramming their administrative systems to reflect the new Code D requirement until mid-April when the instructions were corrected.

In light of this, for a number of companies data feeds with respect to distributions that occurred before mid-April simply could not have included Code D. Even if a company jumped on the task immediately, Code Ds still would be lacking for data feeds with respect to distributions that occurred during the first half of the year, due to the need to design and implement changes to information reporting systems. Some of the companies that use periodic data feeds may be able, with additional programming, to generate corrected 1099-R withdrawal data retroactively to January 1, 2013. For other companies that use periodic data feeds, however, the only option available will be to use manually intensive processes to identify and correct the data feeds that occur before administrative systems can be modified. Manual processing can be slow, and to the extent that it involves a large volume of Forms 1099-R, it can be expensive and error-prone as well.

Distinguishing qualified and non-qualified annuities. Code D is not required to be included on a Form 1099-R filed in connection with a distribution from a “qualified” annuity contract, *e.g.*, an individual retirement annuity or a section 403(b) annuity. This is because such distributions are exempt from the NII Tax. Some information reporting systems do not distinguish between qualified and non-qualified annuity contracts (other than IRAs, for which there is already a separate box on the Form 1099-R that must be checked).⁶ These systems may need to undergo additional changes in order to flag only non-qualified annuity contracts for the inclusion of Code D. As an illustration of the scope of this problem, one company explained to us that based on last year’s volume of Forms 1099-R for annuities it expects there will be about 450,000 Forms 1099-R where it will now need to distinguish between non-qualified and qualified annuities on the tax record it has already generated or will generate by year-end.

Use of multiple distribution codes. Even if an information reporting system can distinguish between qualified and non-qualified annuities, in some cases the system is not designed to automatically generate multiple distribution codes on a single Form 1099-R for a non-qualified annuity. This is because, prior to Code D being introduced, multiple distribution codes were generally required only in connection with *qualified* annuities and not in connection with *non-qualified* annuities. Thus, for example, if a company had a low volume of qualified annuities in force, relying on a manual process to include multiple distribution codes on Forms

⁵ In some cases, the data is transferred to another system at the company or to a third party vendor.

⁶ A company’s general administration system will distinguish between qualified and non-qualified annuities, but the tax records generated at the time of a withdrawal to be used for preparing Forms 1099-R later in the year do not necessarily need to distinguish between such contracts unless the contract is an IRA.

1099-R filed with respect to such contracts was not unduly burdensome. Now, however, it appears that multiple distribution codes will be required on every Form 1099-R issued with respect to a non-qualified annuity contract. As a result, companies with an information reporting system that relies on a manual process to include multiple distribution codes now will need to either manually add Code D to every Form 1099-R issued in connection with a non-qualified annuity or make programming changes to their systems to eliminate the manual process.

Modifying systems and relying on manual processes. It will take time and the reallocation of scarce programming resources to modify and test administrative systems to conform to the revised instructions. For example, one major annuity writer that uses monthly data feeds issues over 1,000,000 Forms 1099-R annually just for non-qualified annuity and life insurance contracts. This company explained that it will have to modify several systems that feed data into its tax reporting system and that the tax reporting system will then need to be modified by the third party vendor of the system. Given the scope of the project, this company does not know whether it will be able to complete the programming by year-end, and, even if it does so, all prior distributions would need to be identified and coded *via* a manual process. Several other member companies of the Committee and the ACLI find themselves in a similar situation, meaning that potentially millions of Forms 1099-R could require the use of a manual process in order to comply with the new requirement for the 2013 tax year.

As indicated above, manual processes are slow and, to the extent they involve large volumes of tax records, can be expensive and error-prone. Even if the reprogramming could be accomplished in a way that obviates the need for a manual process to add Code D, which some companies may be able to do, the reprogramming will still take time and the allocation of significant resources. Had the companies been given more advance notice of the new reporting requirement, perhaps the timing and resource issues would be less significant, but in light of when and how the new requirement was announced these issues will almost certainly present significant difficulties for a number of companies.

Request for Transition Relief

In light of the foregoing, we urge the Treasury Department to delay the new reporting requirement until the 2014 tax year. Delaying the requirement will provide life insurers with sufficient time to modify and test their systems to assure correct reporting with respect to transactions occurring in 2014. The delay will also avoid the costs and errors that will inevitably result from the use of manual processes to identify and correct potentially millions of transactions affected by the new requirement.

We believe the delay is highly unlikely to result in any under-reporting of distributions subject to the NII Tax on individuals' 2013 tax returns. Life insurance companies will still issue Forms 1099-R with respect to any such amounts even if the forms do not include Code D. And, the 2013 instructions to Form 1040 undoubtedly will provide details on what types of income are subject to the NII Tax and how to reflect those amounts on the return.

In addition, we believe that the delay we have requested is consistent with the delayed effective date of the regulations under section 1411. The Treasury Department released the

proposed regulations in December 2012 and, with one exception not relevant here, they are proposed to be effective for taxable years beginning after December 31, 2013.⁷ Of course, this delay in the effective date of the regulations does not delay the effective date of the statutory requirements under section 1411. Likewise, the delay we are requesting with respect to the reporting requirement would not delay or undermine the effective date of section 1411. Finally, the proposed regulations did not mention any changes to the reporting requirements under section 6047(d), such as the addition of the new distribution Code D as described in the instructions to Form 1099-R.⁸ Thus, there was no opportunity for public comment on the timing of the new reporting requirement before it was described in the version of the Form 1099-R instructions released in February.

For all of the reasons summarized above, we request that the new reporting requirement be deferred until the 2014 tax year. We also ask that our request be acted upon as soon as possible. Companies will need to decide soon whether they have to develop a plan to gather the data needed to use Code D for distributions that occurred prior to the release of the revised instructions in mid-April and, if so, identify the resources that will be necessary to implement the plan. In the absence of a timely announcement of relief, companies may well feel the need to take the costly steps necessary to be able to assign Code D to distributions that occurred in the first half of 2013 to protect themselves from penalties.

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Thank you for your consideration of this request. We will follow up with you in the coming days to discuss this matter further. If you have any questions in the meantime, please contact either of us.

Sincerely,



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cc: Cameron Arterton, Associate Tax Legislative Counsel, Treasury Department
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⁷ The one exception is Prop. Treas. Reg. section 1.1411-3(c)(2) (regarding special rules for charitable remainder trusts), which is proposed to apply to taxable years beginning after December 31, 2012. Taxpayers can rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. 77 Fed. Reg. 72,632.

⁸ There are only two collections of information described in the proposed regulations. The first is in Prop. Treas. Reg. section 1.1411-7(d) (regarding partnerships and S corporations) and the second is in Prop. Treas. Reg. section 1.1411-10(g) (regarding controlled foreign corporations and passive foreign investment companies).