[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS

(S. 829, S. 1607, S. 1645, S. 1855, and S. 1888)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE

ON DECEMBER 4, 1981

PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on December 4, 1981, by the Senate Finance Subcommittee on Savings, Pensions, and Investment Policy.

There are five bills scheduled for the hearing: S. 829 (relating to cost-of-living increases in annuities for survivors of Tax Court judges), S. 1607 (relating to permanent extension of, and increase in, dividend and interest exclusion), S. 1645 (relating to investments in collectibles under certain retirement arrangements), S. 1855 (relating to certain State judicial retirement plans), and S. 1888 (relating to tax treatment of certain variable annuities).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of provisions, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 829—Senator Baucus

Cost-of-Living Increases in Annuities for Survivors of Tax Court Judges

The bill would provide cost-of-living increases for annuities payable to survivors of judges of the Tax Court by providing that the annuities generally would be increased as the salaries of judges of the Court are increased, but at a lower rate.

Generally, the bill would apply after the date of enactment. However, a catch-up provision is provided for annuities presently in pay status.

2. S. 1607—Senators D'Amato, Hawkins, Durenberger, Specter, Bradley, Mitchell, Cochran, Helms, and Heinz

Permanent Extension of and Increase in Dividend and Interest Exclusion

Individuals may exclude from income up to $200 ($400 on a joint return) of dividends and interest earned from domestic sources in 1981. After 1981, individuals may exclude from income up to $100 ($200 on a joint return) of dividend income. The Economic Recovery Tax Act of 1981 provides for a 15-percent net interest exclusion on up to $3,000 of net interest ($6,000 on a joint return), effective in 1985 and subsequent years. For taxpayers who itemize deductions, interest is eligible for this new exclusion only to the extent that it exceeds the taxpayer's qualified interest expense. In general, qualified interest expense is deductible interest paid or incurred by the taxpayer during the year, other than interest on a home mortgage or interest paid or incurred in the taxpayer's trade or business.

The bill would make the $200/$400 dividend and interest exclusion permanent. In addition, beginning in 1985, the bill would allow taxpayers to exclude (1) $200 ($400 on a joint return) of dividends and interest income, plus (2) the lesser of $250 ($500 on a joint return) or the amount of qualified excess interest. Qualified excess interest would be 15 percent of the excess of interest income, reduced by $200 ($400 on a joint return), over qualified interest expenses for the taxable year.

The provisions making the current dividend and interest exclusion permanent would apply to taxable years beginning after December 31, 1981. The additional exclusion for qualified excess interest would apply to taxable years beginning after December 31, 1984.

3. S. 1645—Senators Moynihan and Symms

Investments in Collectibles Under Certain Retirement Arrangements

Under present law, individuals generally may self-direct investments under individual retirement accounts (IRAs) or under an account in a qualified plan. Under the Economic Recovery Tax Act of 1981, amounts invested in collectibles (antiques, art, gems, stamps, etc.) under an IRA or an individually-directed account in a qualified plan are to be treated as distributions for income tax purposes. The 1981 Act provision will be effective for acquisitions of collectibles after December 31, 1981.

The bill would repeal the 1981 Act provision with respect to the treatment of collectibles, with the same effective date as the 1981 Act.

4. S. 1855—Senators Bentsen and Tower

Certain State Judicial Retirement Plans

Subject to certain limits, compensation deferred by an employee under an eligible State deferred compensation plan is excluded from the employee's income until paid to the employee under the plan. If the plan is not an eligible plan, benefits payable under the plan are included in gross income when there is no substantial risk that the benefits will be forfeited.

The bill provides that participants in a qualified State judicial plan would not be subject to the rule requiring participants in an ineligible plan to include plan benefits in gross income merely because there is no substantial risk that the benefits will be forfeited. The bill would apply to taxable years beginning after December 31, 1978.

5. S. 1888—Senators Symms, Grassley, Durenberger, and Chafee

Tax Treatment of Certain Variable Annuities

Under Revenue Ruling 81-225, earnings on shares of a mutual fund purchased with amounts invested under a wraparound annuity contract generally are taxed currently to the contractholder, if the shares are available for purchase by the general public. The bill generally would codify the result reached in the Revenue Ruling. The bill would preclude the retroactive application of Rev. Rul. 81-225, which was released on September 25, 1981, and generally would apply to amounts invested under a variable annuity contract after that date.

II. DESCRIPTION OF THE BILLS

1. S. 829—Senator Baucus

Cost-of-Living Increases in Annuities for Survivors of Tax Court Judges

Present Law

Present law provides that, at the election of a judge of the United States Tax Court, three percent of the judge's salary is withheld and credited to the "Tax Court judges survivors annuity fund." If a judge electing coverage under the survivors annuity fund dies while a judge and after completing at least five years of service for which salary was withheld for the fund (or for which salary was withheld under the civil service retirement laws), a surviving spouse or surviving dependent child is entitled to an annuity from the fund. If the surviving spouse has not attained age 50 at the date of the judge's death, the annuity commences when the surviving spouse attains age 50. The annuity payable to a surviving spouse terminates upon the spouse's remarriage or death. The annuity payable to a child generally terminates when the child attains age 18.

The annuity payable to a surviving spouse of a judge is equal to a stated percentage (generally 1¼ percent) of the average annual salary (whether judge's salary or compensation for other allowable Federal service) for the five consecutive years for which the judge received the largest average annual salary, multiplied by the sum of the judge's years of judicial or other allowable Federal service. However, the annuity for the surviving spouse cannot exceed 37½ percent of such average annual salary. The amount of the annuity payable to a surviving dependent is based upon the annuity payable to a surviving spouse (subject to certain limits).

The annuity payable to a surviving spouse or surviving dependent is not adjusted for cost-of-living increases.

Issue

The issue is whether the annuity payable to a surviving spouse or a surviving dependent of a Tax Court judge should be adjusted for cost-of-living increases in the future and whether a cost-of-living adjustment should be made retroactively for survivor annuities presently in pay status.

Explanation of the Bill

The bill would adjust an annuity payable to a surviving spouse or a surviving dependent of a Tax Court judge for cost-of-living increases by increasing the amount of the annuity when the salary of judges of the Tax Court is increased.

The bill would affect each annuity payable from the survivors annuity fund which is based in whole or in part upon a deceased judge having rendered some portion of his or her final 18 months of service as a judge of the Tax Court. Under the bill, each such annuity would be increased by three percent for each five percent when the salaries of judges of the Tax Court are increased. If the salary increase is less than five percent, the increase would be disregarded in computing current and future survivor annuities.

The bill includes a catch-up provision for survivor annuities in pay status on the date of enactment. Under this provision, such an annuity would be immediately increased to reflect increases in the salary of judges of the Tax Court after December 31, 1970.

Effective Date

Except as described in the catch-up provision for survivor annuities in pay status, the bill would apply with respect to increases in the salary of judges of the Tax Court taking effect after the date of enactment.

Revenue Effect

It is estimated that the bill would increase fiscal year budget outlays by less than $50,000 annually.

2. S. 1607—Senators D'Amato, Hawkins, Durenberger, Specter, Bradley, Mitchell, Cochran, Helms, and Heinz

Permanent Extension of and Increase in Dividend and Interest Exclusion

Present Law

Present law (section 116, as it applies to taxable years beginning after December 31, 1980, and before January 1, 1982) provides that up to $200 ($400 for joint returns) of dividend and interest income from certain domestic sources is excludible from gross income. The Economic Recovery Tax Act of 1981 (Public Law 97-34) repealed this exclusion, effective for taxable years beginning in 1982. For taxable years beginning after 1981, individuals will be able to exclude from gross income up to $100 of dividend income ($200 on a joint return). Taxpayers who invest in a qualified savings certificate may exclude from income up to $1,000 ($2,000 on a joint return) of interest earned on such savings certificates issued by commercial banks, thrift institutions, or credit unions.[1]

Effective in 1985, taxpayers will be able to exclude 15 percent of up to $3,000 of net interest ($6,000 on a joint return) (new Code sec. 128). Thus, the maximum exclusion will be $450 ($900 on a joint return). Net interest generally is defined as interest received by the taxpayer in excess of interest payments by the taxpayer for which an income tax deduction is allowed. However, mortgage interest and trade or business interest is not taken into account to reduce the amount of interest eligible for the exclusion. Mortgage interest, for this purpose, is interest paid on debt incurred to acquire, construct, reconstruct, or rehabilitate property the taxpayer uses primarily as a dwelling.

Interest eligible for the exclusion includes: (1) interest on deposits received from a bank; (2) interest (whether or not designated as interest) paid in respect to deposits, investment certificates, or withdrawable or repurchasable shares by a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, credit union, or other savings or thrift institution chartered and supervised under Federal or State law if the deposits or accounts of the institution are insured under Federal or State law, or protected and guaranteed under State law; (3) interest on bonds, debentures, notes, certificates, or other evidences of indebtedness of a domestic corporation which are in registered form; (4) interest on other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public to the extent provided in regulations issued by the Treasury; (5)

[1] Qualified savings certificates are one-year obligations issued between October 1, 1981, and December 31, 1982. The certificates must pay interest at rates equal to 70 percent of the rate on the most recently issued 52-weeks Treasury bills. There are also certain requirements for investment of the proceeds from such savings certificates.

interest on obligations of the United States or a State or local government which is not already excluded from gross income; (6) interest attributable to a participation share in a trust established and maintained by a corporation established pursuant to Federal law (for example, interest attributable to a participation share in a trust established and maintained by the Government National Mortgage Association); and (7) interest paid by an insurance company under an agreement to pay interest on prepaid premiums, life insurance proceeds left on deposit, and, to the extent provided for in Treasury regulations, other amounts left on deposit.

Issue

Two general issues arise in connection with the bill. These are (1) whether the $200/$400 dividend and interest exclusion scheduled for repeal in 1982 should be made permanent and (2) whether the 15-percent net interest exclusion scheduled to take effect in 1985 should apply in addition to the $200/$400 exclusion.

Explanation of the Bill

Under the bill, individuals could exclude from income up to $200 ($400 on a joint return) of dividends and interest earned from domestic sources for taxable years beginning in 1982, 1983, or 1984. For taxable years beginning after December 31, 1984, the interest and dividend exclusion would be the sum of (1) $200 ($400 on a joint return) plus (2) the lesser of $250 ($500 on a joint return) or the qualified excess interest amount. Thus, the maximum interest and dividend exclusion for 1985 and subsequent years would continue to be $450 ($900 on a joint return).

The qualified excess interest would be 15 percent of the excess of interest income, reduced by $200 ($400 on a joint return), over qualified interest expenses for the taxable year. Qualified interest expenses generally would be the excess of total deductible interest over home mortgage interest and trade or business interest.

The operation of this provision can be illustrated by the following example. Assume that, in 1985, an unmarried taxpayer has interest income of $5,200 and deductible interest expenses of $6,000 ($2,000 of which is interest on a home mortgage). For the year, the taxpayer's exclusion would be $350, that is, $200 plus qualified excess interest of $150. Qualified excess interest would be 15 percent of the excess of $5,000 ($5,200 reduced by $200) over $4,000 ($6,000 deductible interest expense reduced by $2,000 home mortgage interest).

Under present law, the exclusion for 1985 would be $180, that is, 15 percent of the excess of $5,200 (interest income) over $4,000 ($6,000 deductible interest expense reduced by $2,000 home mortgage interest).

The bill would repeal the 15-percent net interest exclusion (new Code sec. 128, to be effective for taxable years beginning after December 31, 1984). The definition of interest, for purposes of the bill (both for purposes of the extension of the present law dividend and interest exclusion and the additional exclusion for qualified excess interest), would be the same as the definition of interest for purposes of the 15-percent net interest exclusion added by the Economic Recovery Tax Act of 1981 (see *Present Law* above.)

Effective Dates

The extension of the current dividend and interest exclusion would apply to taxable years beginning after December 31, 1981. The additional exclusion for qualified excess interest would apply to taxable years beginning after December 31, 1984.

Revenue Effect

It is estimated that the bill would reduce fiscal year budget receipts by $600 million in 1982, $2.7 billion in 1983, $2.8 billion in 1984, $2.3 billion in 1985, and $2.1 billion in 1986.

3. S. 1645—Senators Moynihan and Symms

Investments in Collectibles Under Certain Retirement Arrangements

Present Law

In general

Broad discretion generally is allowed with respect to investments by individual retirement accounts (IRAs) and tax-qualified pension, profit-sharing, or stock bonus plans if self-dealing is not involved.[1] Investments by IRAs or by individually directed accounts of employees under qualified plans are not governed by the prudent man and diversification standards of the Employee Retirement Income Security Act of 1974 (ERISA).

An individually directed account is an account in a qualified defined contribution plan. (*e.g.*, a profit-sharing plan) which permits the plan participant to exercise investment control over the assets in the participant's account.

Only a bank, insurance company, or other qualifying financial institution can act as an IRA trustee or custodian. However, the owner of an IRA can self-direct the investment of assets in the account.

1981 Act amendment

The Economic Recovery Tax Act of 1981 (Public Law 97-34) amended the Code generally to discourage IRAs and individually directed accounts in qualified plans from investing in collectibles. Under the Act, an amount in an IRA or in an individually directed account which is used to acquire a collectible is treated as if distributed in the taxable year of the acquisition. The usual income tax rules for distributions from an IRA or from a qualified plan apply, so that the amount considered distributed will generally be included in gross income and may be subject to an additional 10 percent income tax.

A "collectible" is defined as any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other item of tangible personal property specified by Treasury regulations.

The Act applies to acquisitions of collectibles after December 31, 1981.

The adoption of the rule discouraging IRAs and individually directed accounts in qualified plans from investing in collectibles was designed to result in channelling tax-favored retirement savings to investments that contribute to the nation's economic recovery by providing a source of investment capital. There was also concern that the prior law rules, designed to discourage personal

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[1] Special rules apply to investments by qualified plans in employer real estate. Also, investments by pension plans in employer securities are subject to a special limitation.

use of collectibles held for investment by an IRA or under an individually directed account, were not effective.

IRA investments and prohibited self-dealing

Under present law and prior law, if an IRA invests in such a way as to provide for the direct and immediate benefit to the IRA beneficiary (for example, if the account is used for a down payment on the house where he lives), then the entire account is deemed distributed.[2] Accordingly, if an IRA trustee transfers a collectible to the IRA beneficiary for the beneficiary's personal use, the entire amount in the IRA, including the fair market value of the collectible, is includible in the beneficiary's gross income for the taxable year.[3]

Investment and prohibited self-dealing under qualified plans

A distribution from a qualified plan is taxable to the distributee to the extent that the amount distributed exceeds the net amount of the employee's nondeductible contributions to the plan. If tangible personal property (including a collectible) is distributed from a qualified plan, the amount of the distribition for income tax purposes is the fair market value of the property, determined as of the date of the distribution.

ERISA generally prohibits a person who is a fiduciary with respect to a qualified plan from transferring plan assets to (or otherwise providing plan assets for the use or benefit of) any "party in interest," including a plan participant who is an employee of an employer maintaining the plan. In addition, under the Code, such a transfer of plan assets to (or providing plan assets for the use or benefit of) certain employees who are plan participants may constitute a "prohibited transaction" resulting in the imposition of an excise tax.[4]

The excise tax is imposed on the "amount involved" with respect to the transaction. Depending upon the facts and circumstances, this amount may be the fair market value of the asset or only the fair market value of the temporary use of the asset.

Issue

The issue is whether the rule adopted under the 1981 Act which discourages IRAs and individually directed accounts of employees under qualified plans from investing in collectibles should be repealed.

Explanation of the Bill

The bill would repeal the 1981 Act provision discouraging IRAs and individually directed acounts from investing in collectibles.

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[2] See H. Rept. No. 93-1280. 93d Cong., 2d Sess., p. 339.

[3] Unless the beneficiary has attained age 59½ or is disabled, the penalty for early IRA withdrawals (an additional 10-percent income tax) will also apply to the deemed distribution from the IRA.

[4] The excise tax will apply if the individual benefitting from the transaction is an officer, director, or a shareholder (10 percent or more) of the employer, or is a highly compensated employee.

Effective Date

The repeal would apply to acquisitions of collectibles after December 31, 1981.

Revenue Effect

It is estimated that the repeal would have a negligible effect on budget receipts.

4. S. 1855—Senators Bentsen and Tower Certain State Judicial Retirement Plans

Present Law

Eligible State deferred compensation plan

Under present law (Code sec. 457(a)), employees of a State or local government or a rural electric cooperative are permitted to defer compensation under an eligible State deferred compensation plan if the deferral does not exceed prescribed annual limits (generally the lesser of $7,500 or 33⅓ percent of includible compensation). Amounts of compensation deferred by a participant in an eligible plan, plus any income attributable to the investment of such deferred amounts, are includible in the income of the participant or the participant's beneficiary only when paid or otherwise made available under the plan. An eligible plan is not permitted to make benefits available to a participant before the earlier of (1) the participant's separation from the service of the sponsoring entity, or (2) the occurrence of an unforseeable emergency.

Treatment of participants in an ineligible plan

If a deferred compensation plan fails to meet the requirements of an eligible plan, then all compensation deferred under the plan is includible currently in income by the participants unless the amounts deferred are subject to a substantial risk of forfeiture (sec. 457(e)). If amounts deferred are subject to a substantial risk of forfeiture, then they are includible in the gross income of participants or beneficiaries in the first taxable year in which there is no substantial risk of forfeiture.

This rule for the tax treatment of participants in an ineligible plan does not apply, however, if the tax treatment of a plan participant is governed by tax rules for the plan that are set forth elsewhere in the Internal Revenue Code. For example, the rule does not apply if the ineligible plan is a tax-qualified pension plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), or includes a trust forming a part of a nonqualified pension plan (sec. 402(b)).

Issue

The issue is whether participants in certain State judicial retirement plans should be excluded from the rule requiring participants in ineligible plans to include plan benefits in gross income when there is no substantial risk that the benefits will be forfeited.

Explanation of the Bill

Under the bill, participants in a qualified State judicial plan would not be subject to the rule requiring participants in an ineligible plan to include plan benefits in gross income merely because there is no substantial risk that the benefits will be forfeited.

A State's retirement plan for the exclusive benefit of its elected judges or their beneficiaries would be a qualified State judicial plan if (1) the plan has been continuously in existence since December 31, 1978, (2) all judges eligible to benefit under the plan are required to participate and to contribute the same fixed percentage of their basic or regular rate of compensation; and (3) a judge's retirement benefit under the plan is a percentage of the compensation of judges of the State holding similar positions.

In addition, the plan could not pay benefits with respect to a participant which exceed the limitations on benefits permitted under tax-qualified plans, and could not provide an option to plan participants as to contributions or benefits the exercise of which would affect the amount of the participant's currently includible compensation. Further, a State's judicial retirement plan would not be a qualified State judicial plan if judges participating in the plan were also eligible to participate, on the basis of their judicial service, in any eligible State deferred compensation plan.

A plan would be considered as benefitting only a State's elected judges or their beneficiaries even though the plan benefits a judge serving under an appointment to complete the unexpired term of an elected judge.

Effective Date

The provisions of the bill would apply to taxable years beginning after December 31, 1978.

Revenue Effect

It is estimated that the bill would have a negligible effect on revenues.

5. S. 1888—Senators Symms, Grassley, Durenberger, and Chafee

Tax Treatment of Certain Variable Annuities

Present Law

In general

Under present law, tax on interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until amounts characterized as income are withdrawn or annuity payments are received (Code sec. 72(a)). Amounts paid out under a contract before the annuity payments begin, such as policy dividends or payments upon partial surrender of a contract, are first treated as a return of the policyholder's capital and are taxable (as ordinary income) only after all of the policyholder's investment in the contract has been recovered (sec. 72(e)). A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income (under an "exclusion ratio" test),[1] as are policy dividends paid after annuity payments begin.

A life insurance company which issues an annuity contract is not taxed on its investment income[2] to the extent that income is required to be added to its policyholder reserves for the annuity contract (secs. 802(b), 804(a), and 809(a)).

Traditional commercial annuities

A commercial annuity contract is a promise by a life insurance company to pay to the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's capital) and income. The insurance company may take the risk that such amount will be exhausted before the company's liability under the contract ends but may gain if the liability terminates before that amount is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period." Annuity payments may be payable for a period which

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[1] Each annuity payment received is generally allocated between ordinary income and excludable return of capital on the basis of the capital investment in the contract at the time annuity payments begin (the exclusion ratio). This allocation between income and capital continues for all of the annuity payments received by the policyholder even after all capital invested in the contract has been recovered tax-free. If the annuity terminates (for example, by reason of death) before capital is exhausted, no loss deduction is allowed. Under rules applicable to annuities under qualified pension plans, an employee's investment in the contract may be recovered first (Code sec. 72(e)).

[2] Capital gains are taxed to the insurance company unless the annuity is issued under a tax-qualified pension, profit-sharing, or stock bonus plan, an individual retirement annuity, or a tax-sheltered annuity, and the assets under such arrangements are held in segregated asset accounts that are not part of the general assets of the insurance company (Code sec. 804(a)).

depends on the date of an individual's death (a life annuity), for a fixed period of time (a period certain annuity), or for the longer of a specified minimum period or life (an annuity for a period certain and life thereafter).

An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

Variable annuities

If either the premium paid for an annuity contract or the annuity benefit under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is a "variable annuity contract." Under the rules for taxation of variable annuities (1) income credited to invested assets are not taxed to the insurance company, (2) capital gains on invested assets are taxed to the insurance company unless the contract is held under a tax-qualified retirement arrangement (e.g., a contract under a qualified pension plan), and (3) an investor's tax on earnings on amounts invested under the contract is deferred until amounts are withdrawn or benefits paid. Withdrawals and benefit payments are taxed under the usual rules for annuity contracts.

In a series of three rulings commencing in 1977, the Internal Revenue Service has determined that the tax rules for variable annuity contracts do not apply to certain investment vehicles. The first such ruling, Rev. Rul. 77–85, 1977–1 C.B. 12, applies to "investment" annuities. Rev. Rul. 80–274, 1980–2 C.B. 27, and Rev. Rul. 81–225, 1980–41 I.R.B. 5 apply to so-called "wraparound" annuities. Under the Revenue Rulings, earnings on funds invested under an investment or wraparound annuity contract generally are taxed to the individual taxpayer currently, without deferral of the tax until benefits are paid under the contract.

Investment annuities (Rev. Rul. 77–85)

Under an investment annuity contract, an individual could transfer an asset to an insurance company. (Typically, the transferred asset was a certificate of deposit in a bank or savings and loan association, but investments in mutual funds and certain publicly traded securities were also permitted.) Under the contract, the asset was held in a separate acount by the insurer and invested, or reinvested, pursuant to the individual's control.[3] The annuity benefits were based on the investment return and the market value of the assets in the account. The individual could surrender (or partially surrender) the contract at any time before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Under a 1965 "private letter" ruling and numerous subsequent rulings, the Internal Revenue Service held that the usual rules for

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[3] The contracts typically limited investments to assets which could be readily liquidated, for example, savings deposits, listed securities, or mutual funds. Where appreciated assets are transferred under an investment annuity arrangement, the appreciation is subject to tax in the year of the transfer.

taxation of variable annuities applied to investment annuities. In 1975, the Service suspended the issuance of rulings as to investment annuities and, after public announcement of the suspension, held meetings with affected issuers. In 1977, after these discussions, the Service announced its changed position on the taxation of investment annuities.

Under Rev. Rul. 77-85, earnings on assets first invested under an investment annuity contract after March 9, 1977 (the date the ruling was released) are taxed to the individual taxpayer currently, without deferral of the tax until benefits are paid under the contract. The Service's position was based upon the conclusion that the individual possessed such substantial incidents of ownership in the assets in the separate account that such assets were "owned" by the individual (rather than the insurance company) for income tax purposes.[4]

Wraparound bank deposit annuities (Rev. Rul. 80-274)

The principles of Rev. Rul. 77-85 (earnings taxed currently to the individual) were extended by Rev. Rul. 80-274 to certain wraparound bank deposit annuity contracts.

Under the contract described in Rev. Rul. 80-274, an individual could transfer cash, passbook savings, or a certificate of deposit in a savings and loan association to a life insurance company. Under the contract, the asset (reduced by a fee) was deposited by the insurer in a separate account of the originating savings and loan association, and invested in a certificate of deposit. When the certificate of deposit matured, the insurance company was generally required to reinvest the proceeds in another certificate of deposit. The individual could surrender (or partially surrender) the contract before annuity benefits began and receive cash equal to the amount held in the account (less any applicable charges).

Wraparound mutual fund annuities (Rev. Rul. 81-225)

Rev. Rul. 77-85 and Rev. Rul. 80-274 were amplified recently by Rev. Rul. 81-225, which describes several forms of another type of wraparound annuity contract. Under Rev. Rul. 81-225, an individual could purchase for cash a contract which contained provisions common to many annuity contracts, including (1) the right to surrender the contract in whole or in part for cash, subject to a surrender charge or contingent sales fee that decreased the longer the contract was outstanding, and (2) the right, at future dates of the purchaser's choice, to convert the accumulated values under the contract into a stream of periodic payments under one of several settlement options. Net premiums received by the insurance company under the contracts were allocated solely to accounts, the assets of which were invested either in shares of a single mutual fund registered under the Investment Company Act of 1940, or, through subaccounts, in shares of two or more different

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[4] In litigation challenging Rev. Rul. 77-85, the U.S. District Court for the District of Columbia held that the ruling was unreasonable and that the Internal Revenue Service had exceeded its statutory authority in issuing it. On appeal, the order of the District Court was reversed. The appellate court held that the Anti-Injunction Act (Code sec. 7421(a)) barred relief to the plaintiff, marketers of investment annuities, and therefore did not address the merits of the investment annuity issue. *Investment Annuity, Inc.* v. *Blumenthal,* 609 F. 2d 1 (D.C. Cir. 1979), *rev'g* 442 F. Supp. 681 (D.D.C. 1977).

mutual funds identified to the contract purchaser.[5] Typically, the mutual funds were money market funds.

Under Rev. Rul. 81-225, earnings on amounts invested under the contract are taxed to the contract holder currently, without deferral of tax until benefits are paid under the contract, if shares of the mutual fund purchased with amounts invested under the contract are also offered for sale to the general public. The Service's position is based, in part, upon the conclusion that in such a case a contract purchaser's position is substantially identical to what the purchaser's position would have been had the mutual fund shares been purchased directly (in which case, dividends or other distributions made with respect to the shares would be taxed currently to the shareholder). On the other hand, under the Revenue Ruling, earnings are not taxed currently to the contractholder if the mutual fund shares are not offered for sale to the general public, but are available only through the purchase of an annuity contract from the insurance company.

Rev. Rul. 81-225 generally applies to shares of a mutual fund purchased with premiums paid by the contract holder after December 31, 1980. The Revenue Ruling was released on September 25, 1981.

Issues

The issues are (1) whether the results reached in Rev. Rul. 81-225 should be codified by amendment to the Internal Revenue Code, and (2) whether such rules should be applied only to amounts invested under a variable annuity contract after the date the Ruling was released (September 25, 1981).

Explanation of the Bill

The bill generally would codify the result reached in Rev. Rul. 81-225. For tax purposes, an annuity would be defined as including a variable annuity contract with reserves based upon a separate account the assets of which consist of shares of regulated investment companies registered under the Investment Company Act of 1940. However, the bill requires that such shares must not be available for purchase by the general public except through the purchase of a variable annuity contract. If this requirement is met, the shares would be deemed property owned only by the insurance company issuing the annuity contract. Under the income tax rules for variable annuity contracts, dividends and other distributions paid with respect to the shares would not be taxed currently to the contractholder, and tax would be deferred until amounts are withdrawn or benefits are paid under the contract. If, however, the shares are available for purchase by the general public other than through the purchase of a variable annuity contract, under Rev. Rul. 81-225 the shares would be deemed the property of the con-

[5] If premiums were invested in shares of a single mutual fund, an existing shareholder of the mutual fund could exchange his shares for an annuity contract without payment to the insurance company of any fee, sales charge or transfer charge. In addition, the insurance company reserved the right to substitute another mutual fund for the mutual fund first identified to the contract purchaser, if investment in that fund was no longer possible or if the company judged such investment to be inappropriate. If, through subaccounts, net premiums were invested in two or more different mutual funds, the contract purchaser had the right to designate and periodically to reallocate the contract's cash value among the subaccounts.

tractholder, and dividends and other distributions paid with respect to the shares would be taxed to the contractholder currently.

In addition, the bill extends the Revenue Ruling by providing that the investment managers of a regulated investment company, the shares of which are purchased with amounts paid under a variable annuity contract, need not be affiliated with the insurance company issuing the contract. In addition, a variable annuity contract could provide for investment or reinvestment in the shares of more than one regulated investment company (by means of separate accounts or separate subaccounts) at the direction of the contractholder.

The bill also would overturn the retroactive application of Rev. Rul. 81-225. Under the bill, the Revenue Ruling would apply only with respect to earnings on shares purchased with payments made by the contractholder under the contract after September 25, 1981. Earnings on shares purchased with payments made under the contract after December 31, 1980, and before September 25, 1981, would not be taxed currently to the contractholder.

Effective Date

Except as described in that provision of the bill which would overturn the retroactive effect of Rev. Rul. 81-225, the bill generally would apply to contracts entered into or payments made by a contract holder after September 25, 1981.

Revenue Effect

It is estimated that the provision of the bill which would overturn the retroactive effect of Rev. Rul. 81-225 would involve an undetermined, but moderate, revenue loss for fiscal year 1982.

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