

Impact of tax deferral regulations on foreign annuities: information for American investors.

This information, based on the legal opinion provided by our US lawyer, aims to help American investors understand the advantages as well as complexities of investing their money abroad. All efforts have been made to ensure that it is accurate at the date of its publication. It does not constitute investment, legal, tax or other advice nor is it to be relied upon in making an investment decision. We advise our clients to seek the services of their legal advisors.

Since January 12, 2001, the inside build-up of certain foreign annuities is subject to tax according to the IRS's section 1275 regulation. Variable annuities, but not fixed annuities, may be exempt from this rule.

To understand the distinction, it helps to understand what the regulation seeks to do. The problem starts with the statute. The statute says that original issue discount is taxable currently. "Original issue discount" is the unstated interest on a "debt instrument". And a "debt instrument" is a bond (like a Treasury bond), note or "other evidence of indebtedness".

What about annuities?

Fixed annuities are clearly "debt instruments" - promises by the carrier to pay a fixed amount (your premiums) plus earnings. The earnings are OID. U.S. insurance companies realized this problem when the OID rules were under consideration in the 1980's, and they got a last-minute addition to the rules which stated that "annuities issued by an insurance company subject to tax under Subchapter L" - that is, by an insurance company taxable in the U.S. - would not be treated as "debt instruments" (even though they clearly were). That change - simply the result of an effective lobbying effort by the U.S. carriers - secured the tax deferred status of their annuities.

What about annuities issued by foreign carriers?

A foreign insurance company that has no presence in the U.S. is not taxable in the U.S. Therefore, the annuities that it issues are still "debt instruments" subject to the OID rules. In short, while the general rule is that all fixed annuities are debt instruments, there is a narrow exception to this general rule for annuities issued by U.S. carriers. There is no such exception for annuities issued by foreign carriers. The section 1275 regulation merely confirms that - by stating that if a foreign carrier is not subject to U.S. tax on the money it makes by selling the annuity, the annuity remains a debt instrument (and, by implication, the inside build-up on the annuity is OID and is not tax-deferred).

Why aren't variable annuities affected?

Variable annuities are not affected by this regulation for one simple reason: unlike fixed annuities, they are not

debt instruments in the first place and so they are not subject to the OID rules to begin with. As the IRS itself stated in a preamble to OID regulations issued in 1995, before you decide if the OID rules apply, you first have to determine whether you have a "debt instrument". A true variable annuity, in which your return depends on the performance of the underlying portfolio, is not an "evidence of indebtedness". Since it's not a debt instrument to begin with, a variable annuity (unlike a fixed annuity) requires no special rule which says that it will not be treated as a debt instrument. So the IRS's regulation doesn't have anything to do with variable annuities simply because it addresses only annuities that are debt instruments to start with.

Could the IRS treat some variable annuities as debt instruments?

Some variable annuities may be vulnerable. Attorneys who have discussed this issue with Treasury officials understand its position to be that if a variable annuity provides no significant risk to the recovery of capital, it might be properly viewed as a debt instrument. At one time some carriers guaranteed a return of principal on variable annuities - and that may be what Treasury had in mind. And the IRS could conceivably argue that variable annuities that invested only in fixed income obligations should be viewed as debt instruments; still, if there is a chance that the underlying obligation won't be paid (and the carrier is not guarantying that it will be paid), this argument would hard for the IRS to win (and there is no indication that it is making it). In any event, typical variable annuities with equities making up at least part of their underlying investments simply are not debt instruments in the first place and are not effected by the new regulation.

Some people think that the IRS has gone too far in issuing these regulations - that foreign fixed annuities should not be treated differently from U.S. annuities. There may be no logical reason for treating foreign annuities differently, but you can't really blame the IRS for that. The statute is pretty clear (the U.S. carriers made it that way): by special rule, U.S. annuities are not treated as debt instruments; foreign annuities, not having the benefit of a special rule, remain debt instruments subject to the OID rules. It's up to Congress, not the IRS, to extend to foreign fixed annuities the same special treatment that U.S. annuities receive.

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