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Treasury Curbs Tax-Deferral Strategy

New Regulations Limit Use of Insurance, Annuities By Sophisticated Investors

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The Treasury Department released final rules yesterday limiting the use of life insurance and annuities to avoid current taxes on investment earnings.

The Treasury and Internal Revenue Service regulations are aimed at preventing sophisticated investors from using life insurance to turn taxable investments in hedge funds and other "private placement" investments into tax-deferred or tax-free investments. Among the products targeted by the rules, which take effect today, are life insurance and annuity contracts "wrapped" around investments other than the mutual funds found in most retail annuities or insurance. These contracts are marketed primarily to the wealthy.

At the time the rules were released in draft form in July 2003, industry officials said they would mostly affect life-insurance products investing in private opportunities generally not offered on exchanges or to the public, including hedge funds -- lightly regulated investment partnerships -- private placements of shares in a company and nonregistered partnerships.

The rules aren't aimed at typical variable annuities or other investments pitched by the insurance industry to average investors. "It's not affecting the annuities you and I would buy," says Laurie Lewis, a senior vice president at the American Council of Life Insurers.

The Treasury Department said a variable contract based on a segregated-asset account -- in which each buyer's assets are invested separately, without pooling them as with traditional insurance policies -- will not be treated as an annuity or life-insurance contract unless the account "is adequately diversified."

Life insurance and annuities generally enjoy tax deferral on investment earnings, thanks to the insurance components of the contracts. Both variable annuities and variable life-insurance policies -- typically sold by big life-insurance companies, often through banks -- allow buyers to invest money in a number of funds, earning returns that aren't taxed until they are withdrawn. Annuities include a death benefit and sometimes guarantee that the contract's value won't fall beyond certain thresholds.

The ACLI's Ms. Lewis says the trade group supported the changes, which she says were fairly uncontroversial among mainstream life insurers.

She says life insurers stand to benefit because the rules provide "clarity among all the financial instruments."

"You don't have one group with an inappropriate edge," she says.

In the final rules, the Treasury Department and the IRS agreed to grant a temporary reprieve, giving investors a calendar year to unwind existing contracts that don't comply with the new regulations.

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