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SEAC Secondary Guarantees Debate

The following article is presented as a reasonable transcription of a staged debate at a recent meeting of the Southeastern Actuarial Club in Key West, Florida. The topic of the debate was how appropriate are no-lapse secondary guarantees on universal life insurance products.

Resolved: UL products providing secondary guarantees are not required to provide nonforfeiture benefits related to the secondary guarantees.

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Moderator: James D. Atkins, F.S.A., M.A.A.A, Senior Vice President
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Moderator: In order to frame the debate, I will spend just a few moments going over some definitions and issues at the heart of the matter. The definition of a secondary guarantee is a policy provision that keeps a universal life (UL) policy in force, even if the cash surrender value is zero. The Primary Guarantee in a UL plan limits the maximum Cost of Insurance Rates and Expense Charges and the minimum Credited Interest Rate. The policy says as long as the cash surrender value is at least as great as the monthly deduction, the policy will stay in force. This was the only

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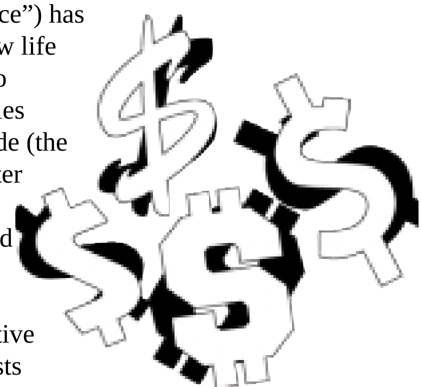
Revenue Procedure 99-27

by Brian G. King & Christian J. DesRochers



The Internal Revenue Service (the "Service") has released the details of a program to allow life insurers to correct inadvertent failures to comply with the modified endowment (MEC) rules under section 7702A of the Internal Revenue Code (the "Code"). Under the program, the Service will enter into closing agreements that will provide that contracts for which premiums have been collected that exceed the aggregate 7-pay limit will not be treated as MECs.

As announced, the revenue procedure is effective as of May 18, 1999, but is limited to relief requests received on or before May 31, 2001. To enter into a closing agreement under the revenue procedure, a life insurance company must file a ruling request, accompanied by a closing agreement. The company must also pay a "toll charge" computed as described in the revenue procedure. In addition, the contracts covered in the closing agreement must be brought into compliance with section 7702A, by increasing the death benefits or by returning the excess premiums and earnings on those premiums to the policyholder.

Because the revenue procedure is generally available to a life insurance company only once (except in limited instances), companies may decide to defer filing their ruling request to a date closer to the expiration date of the revenue procedure (May 31, 2001). However, before a company can decide when to file its ruling request, a significant work effort must first be undertaken, which at a minimum includes the following:

- Determine which contracts meet the definition of "inadvertent MEC."

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- Identify the reasons why contracts inadvertently became MECs.
- Make any necessary system modification to prevent future inadvertent MECs.
- Identify policyholders that may want a MEC.
- Calculate the "toll charge" the company must pay to the Service.
- Determine the corrective action necessary (if any) to bring contracts into compliance with the 7-pay test.
- Assemble the necessary data required for the submission to the Service.

Depending on the number of MECs involved and the availability of historical policy level data, this work effort may be substantial and take several months or more to complete. Companies that can effectively manage this process and understand their financial exposure to "inadvertent MECs" will be in a better position to make the business decision of when to file their ruling request and insure that the ruling request will be filed before the expiration of Revenue Procedure 99-27[1].

Applicability of the Revenue Procedure

There are a number of limitations within the revenue procedure that may limit its applicability. In general, the MEC correction program outlined in the revenue procedure initially appears to be more focused on errors in policy administration, rather than errors in the calculation of the 7-pay limitation. The program applies to contracts that are clearly designed to be non-MECs. The revenue procedure is not available to certain categories of policies, including:

- Policies meeting the Code section 264 definition of corporate-owned life insurance.
- Policies in which the error is "egregious."
- Policies that are highly investment-oriented under standards set forth in the revenue procedure. For example, a policy that, by its terms, is paid-up in less than seven annual premiums is not eligible.
- Policies for which the amount paid in any contract year of the test period exceeds 300% of the 7-pay premium for the contract year.
- Policies reporting a cash surrender value[2] that exceeded the contract holder's investment in the contract within three years after issuance and the assumed 7-pay premium exceeds the correct 7-pay premium by more than 150%.

Because the guidance was designed to encourage insurance companies to voluntarily bring their systems into compliance for all their contracts except for "unusual facts and circumstances," the revenue procedure is generally available to a company only once. This may cause some companies to delay their submissions to a date closer to the end date of the program.

Calculation of the Amount Due

The amount required to be paid with regard to a contract under the terms of the revenue procedure consists of three components. The first two components relate to amounts due as a result of taxable distributions[3]. The third component relates to amounts due on overage earnings. If a taxable distribution occurred on a policy during the period within two years before the date on which the contract became a MEC, the following amounts will be required to be paid:

A) The income tax and the 10% penalty tax under section 72(v) (if applicable) with regards to amounts received (or deemed received). No income tax will be due on amounts already reported to the policyholder as taxable.

B) Deficiency interest computed under section 6621(a)(2) on amounts described in (A) for the tax years in which the amounts were received (or deemed received).

Regardless of whether taxable distributions occurred on a contract, amounts will be due with respect to the overage earnings. This amount is defined as the product of the following three items:

1) the excess, if any, of the contract's cumulative overage earnings over the proportionate share of overage earnings allocable to taxable distributions under the contract, and

2) the applicable tax rate, and

3) the distribution frequency factor.

The cumulative overage earnings is the sum of the overage earnings for each contract year. The overage earnings for a contract year is defined as the overage for that year plus the cumulative overage earnings for all prior contract years times the applicable earnings rate (see following section for a description of the applicable earnings rate). The overage for a particular calendar year is simply the excess, if any, of the sum of amounts paid during the entire test period over the 7-pay limit applicable to that contract year. An offset to the cumulative overage earnings is provided if taxable distributions occurred. This offset is defined as the proportionate share of overage earnings allocable to taxable distributions under the contract and is the product of:

1) the total amount of taxable distributions under the contract, and

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2) a fraction, defined as:
   (a) the cumulative overage earnings, divided by
   (b) the total income on the contract, defined as the cash surrender value less the policyholder's investment in the contract.

The distribution frequency factor is either 0.8 or 0.5 depending on the loan interest rate and withdrawal provisions of a particular contract. For most flexible premium universal life insurance contracts, the distribution frequency factor will be 0.8. Most traditional whole life contracts will have a 0.5 distribution frequency factor[4]. As such, it would appear the 0.8 factor would apply to most contracts eligible for this revenue procedure.

Proxy Earnings Rate

In determining the appropriate contract earnings rates, the calculations in the revenue procedure are not based on actual earnings rates under the contracts. The revenue procedure provides that earnings on excess premiums are to be calculated using a Moody's rate for general account (fixed-rate) contracts and an insurance-industry aggregate rate for variable contracts.

For non-variable contracts, the earnings rate applicable to a contract year is the general account total return for the calendar year in which the contract year begins. The general account total return is the calendar year arithmetic average of the monthly interest rates described as Moody's Corporate Bond Yield Averages—Monthly Average Corporates. For variable contracts subject to 817(d), the earnings rate applicable to a calendar year that begins before January 1, 1999, are specified in the revenue procedure. The earnings rate applicable to a calendar year that begins after December 31, 1998, is derived according to a formula set forth in the revenue procedure.

Applicable Tax Rates

One change in the revenue procedure from prior Service practice is the use of multiple assumed tax rates that vary by the face amount of insurance. In the past, IRS closing agreements under section 7702 imposed a single tax rate of 28%. Similarly, under Rev. Proc. 92-25, the Service applied a 28% marginal rate to all income for variable life insurance contracts. In Rev. Proc. 99-27, the marginal tax rate varies with the amount of the death benefit[5]. The applicable percentage is the marginal tax rate to be applied. It is equal to:

1) 15%, if the death benefit under the contract is less than $50,000

2) 28% if the death benefit under the contract is equal to or exceeds $50,000 but is less than $180,000

3) 36%, if the death benefit under the contract is equal to or exceeds $180,000

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Applicable Earnings Rates

Calendar Year	General Account	Separate Account
1988	10.2%	13.5%
1989	9.7%	17.4%
1990	9.8%	1.4%
1991	9.2%	25.4%
1992	8.6%	5.9%
1993	7.5%	13.9%
1994	8.3%	-1.0%
1995	7.8%	23.0%
1996	7.7%	14.3%
1997	7.5%	17.8%
1998	6.9%	19.7%

Policy Level Data Requirements

The MEC correction program as outlined in the revenue procedure has significant administrative requirements, requiring substantial amounts of data to be submitted, particularly if the submission encompasses more than a few contracts. For each contract, the following information will need to be included in the submission to the Service (which appears to be a request for data in a hard-copy format):

1) specimen copy of the contract form

2) policy number

3) taxpayer identification number of the contract holder

4) original issue date

5) death benefit

6) 7-pay premium assumed when the contract was issued

7) cash surrender value at the end of each contract year

8) a description of the defect(s) causing the contract to fail the 7-pay test

9) a description of the administrative procedures the issuer has implemented to ensure none of its contracts will inadvertently fail the 7-pay test in the future

10) a description of any material changes and the date of each material change

11) information pertaining to each distribution to which section 72 applies:
    (a) the date and amount of each distribution
    (b) the amount of the distribution includible in the contract holders gross income
    (c) the amount of gross income reported to the contract holder and to the Service on a timely filed information return as a result of the distribution
    (d) the date on which the contract holder attained (will attain) age 59½
    (e) whether the distribution is attributable to the contract holder becoming disabled
    (f) whether the distribution is part of a series of substantially equal periodic payments made for the life (or life expectancy) of the contract holder

12) a template setting forth the following information for each contract:
    (a) the cumulative amounts paid under the contract within each contract year of the testing period
    (b) the contract's cumulative 7-pay premium
    (c) the overage, if any, for each contract year
    (d) the earnings rate applicable for each contract year
    (e) the overage earnings for each contract year

Sample Calculations

The revenue procedure details the toll charge calculation for two hypothetical contracts. We have summarized the two examples provided in the revenue procedure and added two of our own.

- Example 1 (see table on page 20) is presented in the revenue procedure. It illustrates the effect of small overpayments made in various policy years.

- Example 1a (see table on page 20) is an example prepared by Avon Consulting Group that illustrates the effect of a consistent early payment of premium on a variable product, so that the policy is out of compliance for only one day each year.

- Example 1b (see table on page 21) is also an example prepared by Avon Consulting Group showing the effect of a material change.

- Example 2 (see table on page 21) is presented in the revenue procedure. It illustrates the effect of a prior taxable distribution.

Example 1: This example is based on a contract with a death benefit of $180,000 and a 7-pay premium of $10,490. The contract has not had any prior distributions. Therefore, the toll charge is simply based on the overage earnings. One of the important features in the determination of the overage amount is that the overage in a particular contract year may remain in the contract provided amounts paid are less than the 7-pay limit in subsequent years[6]. The revenue procedure only requires that the overage earnings be based on the current overage amount, in addition to the cumulative overage earnings for prior contract years.

As illustrated in Example 1, the toll charge is defined in the revenue procedure as the product of the following three items:

- The cumulative overage earnings ($404.37)[7],

- The applicable percentage (36%), and

- The distribution frequency factor (0.5).

The amount required to be paid with regard to this contract is $72.79. In addition, as part of the terms of the closing agreement, the company will be required to bring contracts into compliance with section 7702A, either by an increase in death benefit or by the return of excess premium and earnings, thereon.

Example 1a: This example is based on the same contract characteristics as example 1 (i.e., $180,000 death benefit and a 7-pay premium equal to $10,490) but instead the policy is a variable contract. Therefore, the insurer is required to accept the premium when received. In this example, the premium pattern has been slightly modified so that the policyholder attempts to fund the contract on an annual basis with premium payments equal to the 7-pay premium. In year 1, a payment of $10,490 is received. The second year's payment is applied to the contract one day prior to the anniversary, resulting in a MEC. A similar pattern continues for all subsequent contract years (i.e., the premium is applied to the contract one day prior to the anniversary). The contract is therefore reporting an overage amount each year equal to one 7-pay premium. *Under this example, it appears that the amount required to be paid would be substantial, since the overage earnings seem to assume the overage amount is present in the contract for the full contract year, when in reality the overage amount was only present for one day. If this is correct, the amount required to be paid would be $2,794.51 (.5 times 36% times $15,525.04).*

Example 1b: Contracts undergoing material changes or reductions in benefits may have difficulty meeting the eligibility requirements for this revenue procedure, particularly if the 7-pay limit was not adjusted to reflect the material change or the reduction in benefit. Example 1b is based on the same facts as Example 1, with the exception that a material change (the addition of a qualified additional benefit) occurs at the end of year 5. At the time of the material change, the cash surrender value is assumed to be $60,000. The 7-pay premium for the materially changed contract is $2,450.

By failing to adjust the 7-pay premium for the material change, the contract would not meet the eligibility requirements for this revenue procedure. One of the conditions for eligibility outlined in

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Section 4.03 requires that amounts paid in any contract year not exceed 300% of the 7-pay premium for the contract year. Premiums paid in years 6 and 7 clearly exceed the 300% threshold, which would disqualify the contract for eligibility under the revenue procedure.

Example 2: This example is based on the same facts as example 1 except that a policy loan occurred at the beginning of contract year 5 in the amount of $3,000. At the time of the policy loan, the contract was a MEC. Therefore, the loan should have been reported as a taxable distribution. The gain in the contract at the time of the loan was $4,750 that should have resulted in the full distribution being reported as taxable in the tax year 1996. The amounts required to be paid with regard to this contract are based on the sum of the following:

1) The income tax ($3,000 times 36%) and additional tax[8] ($3,000 times 10%) under section 72(v) due on the $3,000 distribution which occurred in 1996, which equals $1,380,

2) The deficiency interest due under section 6621(a)(2) for the tax that was due in 1996 which equals $237.74 (17.304% times $1,380)[9], and

3) The tax due on the overage amount, which is the product of:
   a) The excess of the cumulative earnings ($404.36) over the proportionate share of overage earnings allocable to the taxable distribution ($83.66)[10], and
   b) The applicable percentage for the contract (36%), and
   c) The distribution frequency factor (0.5).

Numerically the amount required to be paid is 1,380.00 + 237.74 + [.36 x .50 x (404.37 - 83.66)] which equals 1,675.47.

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Footnotes

1) In the past, the Service has continued correction programs beyond the scheduled ending date. However, there is simply no way of telling whether this will be the case for this program.

2) The term “cash surrender value” referenced in Revenue Procedure 99-27 represents the cash value of a contract before surrender charge, as defined in section 7720(f)(2)(A).

3) Revenue Procedure 99-27 contains a special rule for pre-1999 contracts with *de mininis* overage earnings (i.e., overage earnings less that $75). For these contracts, the amount required to be paid is determined without regards to tax and deficiency interest due on prior taxable distributions.

4) The existence of paid-up additions on a traditional whole life contract may require the use of the 0.8 distribution frequency factor.

5) Data that Avon Consulting Group has analyzed with respect to the ownership of individual permanent (cash value) life insurance suggests that the amount of insurance in force generally increases with household income. Given the high correlation between face amount of insurance and household income, we believe that the use of face amount brackets provides a better estimate of the actual tax that would be due if the tax were paid by policy owners.

6) This is particularly important for those MECs that resulted from the payment of a premium just prior to an anniversary where the premium was intended for the following contract year. The overage amount will only exist for one contract year, as the overage will be allowed back into the contract following contract year as a result of the increased 7-pay limit, assuming additional premium is not collected which results in additional overage amounts in subsequent years.

7) Since the policy detailed in Example 1 had no prior distributions, no adjustment is needed to the cummulative overage amount for the proportionate share of overage earnings allocable to taxable distributions under the contract.

8) The example assumes for illustrative purposes that the insured is subject to the additional tax under section 72(v).

9) The deficiency interest rate factor represents the cumulative deficiency interest rate for under payments by an individual taxpayer from April 15, 1997 to March 31, 1999.

10) The proportionate share of overage earnings allocable to taxable distributions is 83.66, which is based on the product of:

1) The total amount of the taxable distribution ($3,000), and

2) A fraction ($404.37 divided by $14,500), the numerator of which is the contracts cumulative overage earnings ($404.37) and the denominator of which is the total income on the contract (specified in the revenue procedure as $14,500).