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A Relatively Favorable Ruling from the IRS on Treatment of Term Riders

by Ed Robbins

The Internal Revenue Service recently released Revenue Ruling 2005-6. This ruling provides formal guidance on how to treat family term riders for purposes of the computational limit calculations in Internal Revenue Code (IRC) sections 7702 and 7702A (i.e., calculations of net single premiums, guideline single premiums, guideline level premiums and 7-pay premiums). The ruling also provides a relatively painless way to grandfather existing policies that may have been administered in a manner out of compliance with the IRS's newly published guidance. This is an issue over which the industry has been in a quandary for over a decade. The issue involves these two IRC Code sections in the following way:

- For purposes of section 7702 (Life Insurance Contract Defined), how do you calculate the increment to the computational limits attributable to family term riders? Do you use the actual charges reasonably expected to be imposed—as is required for Qualified Additional Benefits (QABs) so named in section 7702(f)(5)? Or, can a company use the mortality table applicable to the base policy in determining such increments? What if the rider is simply additional life insurance on the base policy's insured?
- For purposes of section 7702A (Modified Endowment Contract Defined), the same issues exist for the computation of the increment to the seven-pay premium attributable to a family term rider.

Especially for universal life contracts with term riders, this can often make a significant difference in the amount of monies that can be paid into a contract. Moreover, there has been the danger that the wrong historical company practice could put many existing policies out of compliance.

History of the Issue

The original section 7702 was placed in the IRC via the 1984 Tax Act. The issue of family term riders was not considered a problem until the 1988 Tax Act, when the computational limit for mortality and "other than mortality charges" for qualified additional benefit riders—read QABs for purposes of this article—was changed, from reflecting *guaranteed* charges to reflecting charges *reasonably expected to be actually paid*. However, mortality charges on the base contract were not subject to the same requirement. Notice 88-128, issued about that time, generally allowed mortality charges used in the calculations for the base contract to reflect 1980 CSO table mortality—effectively a "safe harbor" for base contract mortality charges.

The 1988 Tax Act, which created section 7702A, included in its legislative history, specifically the Senate Amendment, that "riders to contracts are considered part of the base insurance contract for purposes of the 7-pay test." Thus many of us felt that this was sufficient justification for using the 1980 CSO safe harbor for family term riders, including riders on the base insured, when calculating 7-pay premiums.

Several private rulings were issued in the mid-1990s, most notably Private Letter Rulings (PLRs) 9513015 and 9519023. Under both PLR 9513015 and 9519023, support was given for treatment of term riders as part of the base contract under section 7702A, i.e., for purposes of the 7-pay test, consistent with the above legislative history language. However, for purposes of section 7702 under both of these rulings, term insurance riders on the base insured were taken to be QABs, and thus not covered under the Notice 88-128 safe harbor. The mortality assumptions used in the calculation of the section 7702 computational limits

were accordingly limited to the charges actually expected to be imposed, i.e., a lesser amount than if the 1980 CSO safe harbor were available.

Subsequently, the IRS issued PLR 9741046, which distinguished term riders on the base insured that provided coverage to age 95 (or beyond) from those that provided coverage for a shorter period. For the former "lifelong" contracts, the IRS felt that it was appropriate to treat such riders as part of the base contract and accordingly subject to the mortality charge "safe harbor." Thus, only the shorter duration term riders remained subject to the more restrictive rule, and only for purposes of section 7702, not 7702A.

Meanwhile, many companies did not incorporate the provisions of the above PLRs in practice, as they disagreed with the conclusions of the PLRs based on what they felt were reasonable interpretations of the then current authoritative guidance. In particular, the provisions in section 7702 itself lacked clarity.

Only the provisions applicable to the cash value accumulation test specifically require that determinations with respect to QABs be made using the reasonable charges actually expected to be imposed (see section 7702(b)(2)(B)). A lack of similar specificity under the guideline premium test led many insurers to believe that the Notice 88-128 safe harbor could be used for family term riders, including short duration term riders on the base insured.

In calculating the rider increments to the computational limits under section 7702, they continued to use the 1980 CSO table mortality assumptions instead of the COI charges actually expected to be imposed. That response was not necessarily inappropriate, in as much as PLRs are private rulings. Private rulings, while they are indicative of the thinking of the IRS, are not to be taken as authoritative guidance. That said, this series of events has led to a significant amount of uncertainty given the substantial potential adverse consequences for violating the computational limits under section 7702.

Revenue Ruling 2005-6

This ruling holds that family term riders are QABs, for purposes of both sections 7702 and 7702A. It is not clear whether the IRS has changed its position that short duration term riders on the base insured can be treated as part of the base contract for Modified Edowment Contract (MEC) testing purposes. However, the ruling has provided a streamlined process for accommodating companies that have used the 1980 CSO safe harbor.

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It provides for a closing agreement under which a company has until Feb. 7, 2006 to send an inventory of policies issued on or prior to April 7, 2005 on which it seeks to maintain the old, more generous safe harbor limit. Such inventoried policies will be "grandfathered" from the application of Revenue Ruling 2005-6 for their lifetime. Policies issued after April 7, 2005 must comply with the less generous limit.

There is a fee for filing that inventory. It is a sliding scale based on the number of policies submitted, and it maximizes at $50,000 (for over 10,000 policies). It appears to be well worth the expense in most cases. The ruling, however, does not specify whether the fee scale applies to each corporate entity or to an entire controlled group.

The ruling also contains guidance as to what actions can cause a policy to lose its grandfathering. A policy's grandfathered status will be lost if a new family term rider is added, or there is an increase to an existing rider and the policy owner did not possess a contractual right to such addition or increase prior to April 8, 2005.

On the whole, many practitioners feel that this is a favorable ruling, despite the adverse position the IRS took on the merits of the issues themselves. Grandfathering existing policies is far more preferable than having to change limits on existing policies. ●

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