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Whither the Definition of "Cash Surrender Value"—The IRS Issues More Waiver Rulings Discussing the Meaning of Section 7702(f)(2)(A)

By John T. Adney and Alison Reynolds Peak

The September 2006 issue of *TAXING TIMES* featured an article entitled "Private Rulings Regarding 'Cash Surrender Value' Under Section 7702" written by Craig R. Springfield and Brian G. King. That article discussed two private letter rulings[1] issued by the Internal Revenue Service ("IRS") in 2005 (collectively, the "2005 Rulings") that waived errors relating to the definition of "cash surrender value" under section 7702(f)(2)(A).[2] In the 2005 Rulings, the IRS concluded that certain amounts made available on the surrender of life insurance contracts, called "remittances" in the rulings, represented "cash surrender value" within the meaning of section 7702(f)(2)(A) even though they were not part of the surrender value identified as such in the contracts. In both cases, the IRS waived failures to comply with the requirements of section 7702 because the insurers' errors in interpreting the cash surrender value definition were considered reasonable under section 7702(f)(8). During 2008, the IRS issued two additional waiver rulings that reached a similar conclusion, but in doing so shed more light on the facts involved and addressed the tax treatment of the corrective action itself. The discussion that follows begins with a review of the definition of "cash surrender value" in section 7702(f)(2)(A) and in the regulations proposed under that provision but never finalized. The discussion then recaps the 2005 Rulings, describes the recently issued letter rulings, and concludes with some ruminations about the consequences of the approach being taken by the IRS.

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THE STATUTE AND THE PROPOSED REGULATIONS

Section 7702 constrains the investment orientation of life insurance contracts by requiring, in different ways, that the "cash surrender value" of a given contract have a minimum amount of death benefit associated with it. Much of the complexity of the statute arises from the legislative attempt to define what that minimum amount is. For this purpose, section 7702(f)(2)(A) provides that a contract's cash surrender value is its "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." However, nothing in section 7702 or elsewhere in the Code undertakes to define the more fundamental term, "cash value." When section 7702 was enacted in 1984, the meaning of this term was not in question. After all, nonforfeiture values available on surrender of a contract for cash had been defined in state law for over a century, and to find a contract's cash value, all that one had to do was to read the contract's terms. Just two years prior, the same, simple reference to "cash value" was used in the revision of section 72 to address the treatment of withdrawals from nonqualified deferred annuities, and there again, no elaboration of the term's meaning was provided or requested.

The legislative history of section 7702 furnished little additional guidance on the meaning of "cash value," although what it added as a gloss on the statute both spawned debate and laid the foundation for the 2005 and 2008 private letter rulings. According to the congressional committee reports on the 1984 law, cash surrender value for section 7702 purposes is "the cash value of any contract (*i.e.*, any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend."[3] Further, the committee reports' reference to "and against which the policyholder can borrow" was used in the very same legislative history to justify excluding return-of-premium benefits under credit life insurance contracts from being treated as cash values.[4] However, as the ink was drying on these reports, there apparently was some rethinking on the part of the Joint Committee on Taxation staff about what the talismanic "and" might connote. Perhaps out of some unarticulated concern, the Joint Committee staff's Blue Book on the 1984 law, published in January of 1985, modified the committee reports' statement after the fact by rephrasing it as: "and, generally, against which the policyholder can borrow."[5]

As of this writing, nearly 25 years after the enactment of section 7702, no formal regulatory guidance—whether in the form of regulations or revenue rulings—has been issued on the meaning of either "cash surrender value" or "cash value" as used in section 7702 (or section 72, for that matter). The IRS did try to issue guidance, however. In particular, when it proposed regulations in 1992 primarily to deal with the treatment of terminal illness and other life insurance accelerated death benefits, the IRS addressed those benefits in the context of a fairly elaborate structure defining "cash value" for purposes of section 7702. Under the regulations as proposed, this cash value for any life insurance contract was said to equal the greater of (1) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), "or" (2) the maximum amount that the policyholder could borrow under the contract, all subject to specified exceptions (such as death benefits, accelerated benefits for the terminally ill, and certain termination dividends).[6] Notably, the proposed definition converted the "and" in "and against which the policyholder can borrow" to a decidedly different term, *i.e.*, "or." For this and other reasons, the life insurance industry protested against the broad sweep of the proposal, and less than four years later, the enactment of sections 101(g) and 7702B rendered the principal motivation behind the proposed regulations obsolete.

However, nothing in section 7702 or elsewhere in the Code undertakes to define the more fundamental term, "cash value." When section 7702 was enacted in 1984, the meaning of this term was not in question.

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With the effort to define cash value stewing in controversy and much else to do, the IRS chose to let the proposed regulations lie fallow. Moreover, in Notice 93-37[7] the IRS announced that the effective date of the proposed regulations would be no earlier than the date of their publication as final regulations in the Federal Register. The Notice also said that it was anticipated that insurers generally would be allowed a period of time after the publication of the final regulations to bring their policy forms into compliance with any new rules. This publication has not happened, and so, as a legal construct, the proposed regulations are technically inoperative.

The death of these proposed regulations, however, has likely been exaggerated. As discussed in the previous *TAXING TIMES* article on the subject, even though the cash value definition in the proposed regulations differs materially from the definition in the legislative history, the thinking of the IRS clearly is guided by the former. At one level, this is not surprising, for it is inviting to rely on the all-encompassing and well-articulated, if broken, standard like the one proposed. At the same time, in light of the criticisms leveled against the approach taken in the proposed regulations, let alone the announcement in Notice 93-37, reliance on that standard is questionable policy. Were the IRS to proceed with revising the proposed definition of cash value, to take account of the criticisms and conform the definition to the congressional intent, and then finalizing the new rules with a prospective effective date, this would be a useful step (more on this later). At minimum, it probably would avoid the need of life insurers and the IRS to continue the saga of the letter rulings next discussed.

THE 2005 RULINGS

As described in the *TAXING TIMES* article in 2006, the contracts involved in the 2005 Rulings were fixed and variable, flexible premium contracts designed to comply with the cash value accumulation test of section 7702(a) and (b) (the "CVA Test") or, in some cases, with the guideline premium limitation and cash value corridor tests of section 7702(c) and (d) (the "GP Test"). In both rulings, the contracts provided for a policy value that was available on surrender, and also provided for certain additional amounts—labeled the "remittances" in the rulings—that would be payable on surrender in the early durations of the contracts. Significantly, the contract owners could not borrow under their contracts against these remittances, and since these amounts were not part of the policy value, the insurers involved in the rulings understandably did not reflect them in the "cash surrender value" that was used for CVA Test or GP Test purposes. Rather, only the contracts' policy value was utilized for those purposes, thereby setting up the problem that was taken to the IRS for resolution.

In the 2005 Rulings, the IRS first considered whether the remittances were properly excluded from the cash surrender value of the contracts for section 7702 purposes, and concluded that they were not. For the construction of the cash surrender value definition in section 7702(f)(2)(A), the IRS looked to a number of sources, including a leading insurance textbook that defined a contract's cash surrender value as "the amount made available contractually, to a withdrawing policyholder who is terminating his or her protection"[8] and another one that defined it as "the amount available to the policyholder upon the surrender of the life insurance contract."[9] The IRS also looked to the proposed regulations under section 7702(f)(2)(A), which (as described earlier) swept into the cash surrender value all amounts payable on surrender unless excluded by a specific exception. Applying that standard as well as the teaching of the insurance texts, the agency determined that the remittances needed to be included in the contract's cash surrender value for section 7702 purposes.

The foregoing conclusion meant, of course, that the contracts did not contain the proper formula for compliance with the requirements of section 7702. Recognizing this, the IRS next considered whether the error in not treating the remittances as part of the contracts' cash surrender value was a reasonable one within the meaning of the waiver authority granted in section 7702(f)(8). The ruling letters noted that the language of the legislative history defining the section 7702 cash surrender value was not "identical" to that of the proposed regulations—

a nod to the very different wording of the two when it came to the effect of the contract owner's borrowing rights—and that the proposed regulations had not been finalized. Citing to these facts and to the prospectivity promised in the 1993 Notice, the IRS held the error to be reasonable and used its authority under section 7702(f)(8) to waive the failures.

NEW PRIVATE LETTER RULINGS

After a brief hiatus in waiver ruling activity on this topic,[10] more of the same followed in 2008. In PLR 200841034 (March 28, 2008) (the "2008 Ruling"), the "remittances" again made an appearance as a life insurance company requested a waiver for its failure to include them in its contracts' cash surrender value for purposes of the CVA Test. This time, however, the ruling letter did not first stop to consider whether, on the merits, the remittance amount should be included in or excluded from the cash surrender value. Instead, the IRS focused on the insurer's admission of error and request for a waiver under section 7702(f)(8).

Under the facts of the 2008 Ruling, the insurer issued flexible premium, variable life insurance contracts that were designed to meet the requirements of the CVA Test "by multiplying the Contract's 'Cash Value' by a percentage identified in the Contract," this percentage being "intended to equal the amount required to maintain the Contract's compliance at all times with the CVA test." Not included in this "Cash Value," however, was an additional amount—the remittance—that the insurer guaranteed to pay if a contract were fully surrendered within its first three years. This amount, according to the ruling letter, essentially represented a portion of the premium loads assessed in the year of surrender. The ruling letter noted that the insurer had interpreted the legislative history of section 7702 as providing that the "cash surrender value" is an amount that the owner can both receive on surrender and borrow under the contract, and that as a result of this interpretation, the remittance amount, which was not subject to borrowing, was not included in the section 7702 cash surrender value under the contracts as drafted. Further, because the remittances were not part of the contract's cash value, they

did not grow with interest or earnings, nor did they decrease the net amount at risk, and hence the cost of insurance charges, under the contracts.

The 2008 Ruling then pointed out, still in the "Facts" portion of the ruling letter, that the omission of the remittances from the contract's cash surrender value resulted in the contracts' failure to comply with the CVA Test. This statement of the conclusion is quite interesting, arriving as it does after the recording of facts showing that the remittances did not function like a cash value and before any analysis in the ruling letter as to why they were, nonetheless, part of the cash surrender value under section 7702. While perhaps this approach can be justified on the grounds that the taxpayer admitted error in the first instance, it may be even more revealing of the IRS's (and the taxpayer's) view of the situation. By 2008, it was clear to the IRS and to a number of life insurers that remittance-like items were part of the section 7702 cash surrender value, whether or not they could be borrowed against, whether or not the proposed regulations had been finalized, and regardless of the terms of Notice 93-37. For that matter, such items were accepted as section 7702 cash value even though they apparently have not been so treated under state nonforfeiture law.[11] The analysis in the 2008 Ruling, for its part, generally did no more than the 2005 Rulings: after reviewing the same authorities, including the proposed regulations, noting the discrepancy in the wording on borrowing between the legislative history

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and the proposed (but never finalized) regulations, and further noting that the 1993 Notice indicated that insurers would be allowed to bring their policy forms into compliance with any new rules, the IRS concluded that the failure to satisfy the requirements of the CVA Test should be waived because the taxpayer's error was reasonable.

Then, in a departure from the 2005 Rulings, the 2008 Ruling went into greater detail about the tax treatment of the correction of the error. As in the earlier rulings, the taxpayer corrected the CVA Test compliance error by amending the contracts—in this case, adding an endorsement to the contracts—so that the remittances were included in the contracts' cash value during the period that they could be paid on surrender. This endorsement, according to the 2008 Ruling, was made effective retroactively to the issue dates of the contracts involved. Since this entailed amending the contracts, it presented a question whether the correction resulted in a material change to the contracts, raising the specter of a deemed new issue date for the contracts under the tax law. To preclude this, and presumably relying on the retroactive effective date of the endorsements, the IRS specifically held that the addition of the endorsement to correct the CVA Test failures would not affect the contracts' "issue" or "entered into" dates and did not result in a change in benefits under the section 7702(f)(7) adjustment rule or a material change for section 7702A purposes. As a result, according to the ruling, the endorsement's addition would not affect the contracts' "grandfathered" status for purposes of sections 72, 101(j), 264, 7702, and 7702A, would not affect any testing periods under sections 264(d), 7702, or 7702A, and in general would not give rise to an exchange for tax purposes. This produced a sensible conclusion, for if the correction of compliance problems itself gave rise to a material change under the tax law, the result would be a cascading of troubles for insurers endeavoring to assure that their contracts meet the requirements of section 7702.

The other recent letter ruling, PLR 200901028 (September 29, 2008) (the "2009 Ruling"), mimicked the 2008 Ruling and its forebears in large part, but elaborated on why the additional amounts were being guaranteed by the insurer. In the 2009 Ruling, a life insurance company requested a section 7702(f)(8) waiver for certain contract endorsements that caused its contracts to fail the requirements of section 7702, and further asked for material change relief similar to that requested by the insurer in the 2008 Ruling.

The statement of facts in the 2009 Ruling was similar to that of the 2008 Ruling but provided more detail. According to the ruling, the insurer issued a variety of life insurance contracts to corporate policyholders. Some of these contracts were intended to comply with the CVA Test, and the rest were subjected to the GP Test. The problem arose when the insurer endorsed the contracts involved in the ruling with an amendment that guaranteed a cash surrender value for a specified period of time that was higher than that defined in the base contracts. The ruling recorded that the insurer did so in response to requests from corporate policyholders that this guarantee of a temporarily higher surrender value was necessary to enhance the early duration policy values, so that the contracts did not have a negative effect on the policyholders' profit and loss statements during the early policy years. Further, according to the ruling, the additional surrender benefit provided by the endorsements was "a function of a return of premiums paid and/or a reduction of the charges assessed as of the date of surrender," but it "may not be borrowed against."

The insurer represented to the IRS that due to the addition of the endorsements, the contracts failed the CVA Test by the terms of the contract, and failed the GP Test if they were in the cash value corridor of section 7702(a)(2)(B) and (d) during the period when the additional benefit was available. According to the 2009 Ruling, this failure was attributable to the insurer's erroneous assumption that the amount made available on surrender was not includible in the contracts' cash surrender value for section 7702 purposes, thereby rendering the death benefits provided under the contracts improperly low. The ruling noted, interestingly, that the insurer discovered it had committed this error after reading the 2005 Rulings. This may be the best evidence yet that in the world of insurance taxa-

tion, where published guidance is difficult to come by, both insurers and the IRS look to the body of private letter rulings to divine the mysteries of the Code. As tax professionals in and out of the government recognize, however, private rulings do not constitute precedent for a reason extending beyond the formal rule in section 6110(k)(3), *i.e.*, they do not receive the thorough review that published guidance does. Query, then, whether reliance on the teachings and conclusions of private letter rulings is an appropriate way to administer the tax law, particularly when they emanate from section 7702(f)(8) waiver requests, in which the taxpayers are conceding error. (But we digress.)

In its analysis in the 2009 Ruling, the IRS reviewed the same authorities that were cited in the 2008 Ruling (and its predecessors). On the same reasoning as before, the IRS concluded that the additional cash value guaranteed on surrender for the temporary period should have been included as part of the contracts' cash surrender value for section 7702 purposes, and so it agreed that the insurer's admission of error was correct. Further, following its prior reasoning, the IRS agreed that the error was reasonable and the compliance failures therefore were waivable.

The correction discussion in the 2009 Ruling also followed the pattern of the 2008 Ruling, although with some new facts and an intriguing twist. The insurer proposed to correct its endorsed contracts either by replacing the current endorsements with new ones that complied with section 7702, or by replacing the entirety of the current contracts with new contracts and endorsements that were compliant with the statute. Further, where the new contracts or endorsements were "not in use or available"—presumably meaning not yet approved by the appropriate regulatory authorities—the insurer proposed to provide a "binding letter" to the affected policyholders promising to pay the higher death benefits resulting from the inclusion of the additional benefit as part of the cash surrender value. In connection with these steps, the insurer asked, and the IRS agreed, to hold that "[n]either the failure nor any corrective actions taken will have any effect on the dates the Contracts were issued, entered into or purchased for purposes of §§ 72, 101(j), 264, 7702 or 7702(A) [sic] and will not subject the Contracts to any retesting or restating of a new test period under §§ 264(d), 7702(f)(7)(B) or 7702A(c)." While this holding largely tracked that of the 2008 Ruling, it subtly added "the failure" as the subject of the material change relief. Why should a section 7702 compliance failure itself need such relief? Perhaps it stemmed from the fact that the contracts were endorsed in the first place, and while that endorsement gave rise to the failure, it also represented a material change. That material change would have produced potentially unwelcome consequences under at least some of the listed statutory rules. It may be that the error in the first set of endorsements provided an opportunity to rectify that situation.

CONCLUDING COMMENTS

The 2008 Ruling and 2009 Ruling were in large part a repetition of the 2005 Rulings, and hence were consistent with the IRS's prior ruling position. While the new rulings show that the IRS continues to adhere to its view that the "remittances" and like additions to a contract's formal cash surrender value are properly considered part of the section 7702(f)(2)(A) cash surrender value, they also show that the agency treats the regulatory requirement in this respect—basically the regulations that have remained in proposed form for over 16 years—as unclear to taxpayers, thus warranting the waiver of the resulting compliance failures. The new waiver rulings, coupled with the 2005 Rulings, further suggest that life insurance companies are taking a conservative approach on this subject, being willing to view the amounts in question as part of the section 7702 cash surrender value even in the absence of published guidance requiring it.

Why should a section 7702 compliance failure itself need such relief? Perhaps it stemmed from the fact that the contracts were endorsed in the first place, and while that endorsement gave rise to the failure, it also represented a material change.

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The body of waiver rulings discussed here hint at, but do not directly address, a potentially much more significant subject: the return-of-premium benefits provided under many life insurance contracts today, including term life insurance contracts that do not provide for cash surrender values at all. The 2009 Ruling appears to come closer to this subject than do the others in saying, as quoted above, that the additional surrender benefit with which it was concerned was in part "a function of a return of premiums paid." It may well be tempting to jump from the conclusions of the waiver rulings, and from the all-encompassing formula of the proposed regulations, to judge all return-of-premium benefits to be cash surrender values, or parts of other cash surrender values, within the meaning of section 7702(f)(2)(A). Sound discretion, however, should dictate a more careful consideration of the matter. As a procedural matter, the waiver rulings, being private letter rulings, are not precedential, and the proposed regulations are not effective, as witnessed by Notice 93-37. On the merits, those proposed regulations are all too all-encompassing, extending the cash value definition well beyond the thinking of Congress, which the courts would say should be construed to reflect what cash value, as a term of art, was understood to mean under state insurance law *circa* 1984. When Congress has considered benefits that merely return premiums paid, it has not viewed them in the same manner as insurance or annuity cash values that possess a savings element, and hence it has (as noted above) excluded such benefits provided under credit life insurance from cash surrender value treatment under section 7702, and also it has permitted such benefits under "qualified" long-term care insurance contracts (under section 7702B) while generally banning cash surrender values from those contracts. Hence, while treating return-of-premium benefits as cash surrender values may be appealing to the IRS, the transit from disregarding those benefits to fully recognizing them under section 7702(f)(2)(A) is not a simple matter, or a trip that should be taken lightly.[12]

What, then, is the magic solution? A new regulatory project may be the simplest, most straightforward way to put to rest all of the outstanding questions. This could involve the issuance of a new notice of proposed rulemaking that updates, revises, and narrows the cash surrender value definition put forth in the 1992 proposed regulations. If this were done, accompanied by the required invitation for comment and by appropriate transition provisions, it would represent a significant step forward in enabling compliance with section 7702. ◀

END NOTES

1. PLR 200521009 (February 22, 2005); PLR 200528018 (April 12, 2005).
2. All references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
3. S. PRT. No. 98-169, vol. I, at 573 (1984); H.R. REP. NO. 98-432, pt. 2, at 1444 (1984).
4. *Id.*; STAFF OF J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 648 (Comm. Print 1984) ("1984 Blue Book").
5. 1984 Blue Book at 647.
6. Prop. Treas. Reg. § 1.7702-2(b)(1).
7. 1993-2 C.B. 331.
8. KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE & HEALTH INSURANCE 46 (13th ed. 2000).
9. JOHN H. MAGEE, LIFE INSURANCE 599 (3d ed. 1958).
10. There was another private letter ruling addressing the section 7702(f)(2)(A) cash surrender value definition during the interim, but it was not a waiver ruling. That ruling, PLR 200745006 (August 9, 2007), involved a request for an affirmative ruling on the application of that definition, although the redacted version of the ruling released to the public does not disclose much information about the precise nature of the ruling requested or about the insurance product involved. Based on what can be gleaned from the non-redacted portions of the letter ruling, some amount greater than the "policy value" of the base contract would be payable on surrender if the contract was issued with a particular rider. Consistently with its ruling policy on the waiver rulings discussed herein, and citing to the same authorities and rationale as in the waiver rulings, the IRS held that the greater amount payable on surrender needed to be recognized as the cash surrender value for section 7702 purposes.
11. Interestingly, at times the IRS has been of two minds on the seeming breadth of the cash value definition. The amount a life insurer's deduction for the increase in its reserve for a contract under section 807 is dependent in part on the contract's "net surrender value," which section 807(e)(1)(A) defines as essentially the contract's cash value determined without regard to surrender charges. In audits of life insurers' taxes, the IRS has contended that a contract's net surrender value was less than its full nonforfeiture value, even after reduction for surrender charges, at least where all of that nonforfeiture value could not be realized during the taxable year at issue.
12. *See also* National Association of Insurance Commissioners, "Actuarial Guideline CCC – The Application of the Standard Nonforfeiture Law for Life Insurance to Certain Policies Having Intermediate Cash Benefits," relating to *inter alia* the treatment of return of premium benefits under state nonforfeiture law. This guideline, adopted last year, is applicable "for all policy forms filed on or after January 1, 2009, and affects contracts issued on or after January 1, 2010."