SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2005 – Volume 1, No. 1

Revenue Ruling 2005-6: Guidance on QABs under IRS Sections 7702 and 7702A

John T. Adney, Joseph F. McKeever III and Craig R. Springfield

On January 19, 2005, the Treasury Department and the Internal Revenue Service (the "Service") responded to a life insurance industry request[1] for guidance on the treatment of qualified additional benefits ("QABs") under sections 7702 and 7702A of the Internal Revenue Code through the release of Revenue Ruling 2005-6 (the "Ruling").[2] The Ruling provides two important pieces of guidance. First, it confirms the position that the Service had taken in private letter rulings that charges for QABs are subject to the "reasonable expense charge rule" of section 7702(c)(3)(B)(ii), and not the "reasonable mortality charge rule" of section 7702(c)(3)(B)(i), for purposes of determining whether a contract qualifies as a life insurance contract under section 7702 or constitutes a modified endowment contract under section 7702A (a "MEC"). Second, in response to the concerns that companies had expressed to the Treasury Department and the Service, the Ruling provides special transition relief – both generous and without precedent under the statutes affected – for issuers whose compliance systems have not properly accounted for QABs.

Statutory Framework

Section 7702 sets forth a definition of a "life insurance contract" for purposes of the Internal Revenue Code. In order to meet that definition, a contract that is a life insurance contract under applicable, e.g., state, law must (1) satisfy the "cash value accumulation test" (the "CVA test"), or (2) meet certain "guideline premium" and "cash value corridor" requirements (the "GP test"). Also, a contract that constitutes a life insurance contract under section 7702 will be characterized as a MEC (resulting in less favorable tax treatment than non-MEC life insurance contracts) if it fails to meet the "7-pay test" of section 7702A (or is received in exchange for a contract that is a MEC).

The Code sets forth rules regarding the assumptions with respect to mortality and expense charges that must be used in determining net single premiums under the CVA test, guideline premiums under the GP test, and 7-pay premiums under the 7-pay test. In particular, such determinations must be made in accordance with the reasonable mortality charge rule and reasonable expense charge rule of sections 7702(c)(3)(B)(i) and (ii), respectively. The reasonable mortality charge rule provides, in part, that the determinations must be based on reasonable mortality charges that do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued. (For contracts issued in the past, these mortality charges generally are ones based on the 1958 or 1980 Commissioners Standard Ordinary ("CSO") tables, depending on when the contract was entered into. The Service provided guidance last year in Notice 2004-61,[3] regarding when determinations for newly issued contracts would need to be based on the 2001 CSO tables.) While the reasonable mortality charge rule requires mortality charges to be "reasonable," it does not require that the charges taken into account be charges that are expected to be actually paid. In contrast, the reasonable expense charge rule provides that determinations under sections 7702 and 7702A must also be based on "any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid."

Determinations of guideline premiums, net single premiums and 7-pay premiums under sections 7702 and 7702A generally are made with respect to the "future benefits" under a contract, which includes the amount of any death or endowment benefit. Also, reasonable expenses other than with respect to QABs may be taken into account in determinations of guideline premiums, but not for net single premiums or 7-pay premiums. For QABs, the Code imposes what can almost be thought of as a hybrid rule. Specifically, under section 7702(f)(5)(B), the charges for QABs are treated as future benefits that can be reflected in the determinations, rather than the benefits actually provided by a QAB. Section 7702(f)(5)(A) defines QABs as any (i) guaranteed insurability benefit, (ii) accidental death or disability benefit, (iii) family term coverage, (iv) disability waiver benefit or (v) other benefit prescribed under regulations (although no such regulations have been prescribed).

John T. Adney is a partner with the Washington, D.C. law firm Davis & Harman LLP. He may be reached at *jtadney@davis-harman.com.*

Joseph F. McKeever III is a partner with the Washington, D.C. law firm Davis & Harman LLP. He may be reached at *jfmckeever@davis-harman.com.*

Craig R. Springfield is a partner with the Washington, D.C. law firm Davis & Harman LLP. He may be reached at *cspringfield@davis-harman.com.*

[1] *Davis & Harman LLP submitted the request on behalf of a group of life insurance companies in June, 2003. Also, the American Council of Life Insurers, the principal life insurance industry trade association, subsequently made a similar request.*

[2] *2005-6 I.R.B. 471. Also, references herein to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").*

[3] *2004-41 I.R.B. 596.*

Past Practices of Insurers and Private Rulings from the Service

Despite, or perhaps because of, the special rule for QABs treating their charges as "future benefits," many insurance companies adopted an interpretation of the Code's requirements that differs from the position ultimately adopted by the Service in the Ruling. While it is clear under the applicable statutory rules that QAB charges are treated as "future benefits," rather than the QABs themselves, for purposes of making determinations under sections 7702 and 7702A, what has been unclear is whether those charges are subject to the reasonable mortality charge rule or the reasonable expense charge rule. If the reasonable mortality charge rule governs, it typically would be permissible for the guaranteed charges for the QAB to be reflected in the determinations. In contrast, if the reasonable expense charge rule governs, only such charges that are reasonably expected to be actually paid may be reflected. Given that expected actual charges for QABs are in many cases materially less than 1980 CSO-based charges (or the guaranteed charges for the QABs), there can be a significant difference between the guideline premiums, net single premiums and 7-pay premiums resulting from application of one rule versus the other.

Many life insurance companies have taken the position that the reasonable mortality charge rule applies in accounting for QABs under sections 7702 and 7702A. As noted earlier, under section 7702, charges for QABs are treated as "future benefits" under section 7702, which is the same way that death benefits are treated. For death benefits, it is clear that the reasonable mortality charge rule governs how the benefit is reflected in the determinations under sections 7702 and 7702A. Many companies concluded that Congress' intent was to treat QAB charges, given their status as future benefits, in the same manner. Reinforcing this view is the fact that the reasonable expense charge rule, on its face, states that it only addresses expense charges "other than mortality charges." Some reasoned that since family term coverage QABs (which are perhaps the most significant QABs in terms of the effect they often have on the determinations under sections 7702 and 7702A) involve charges that economically are comparable to mortality charges, there existed an especially strong case for applying the reasonable mortality charge rule to account for such QABs. Thus, in the case of family term coverage, whether due to the treatment of QAB charges as future benefits or due to the underlying economic nature of the charges, it was difficult for insurance companies to reconcile application of the reasonable expense charge rule with the statutory prescription that this rule, on its face, does not apply to account for "mortality charges."

In 2001, the Service issued the first in a series of private letter rulings which concluded that the reasonable expense charge rule applies to QABs and that the insurance company's failure to apply such rule was a reasonable error and consequently waived pursuant to section 7702(f)(8). (See PLR 200320020 (Feb. 6, 2003), PLR 200227036 (April 19, 2002), PLR 200150018 (Sept. 13, 2001), and PLR 200150014 (Sept. 12, 2001).) These private letter rulings were not precedential (i.e., they could be relied upon only by the taxpayers requesting them) and were issued to life insurance companies that acknowledged error with respect to their treatment of QABs under section 7702. The effect of the rulings is that, with respect to the failed life insurance contracts identified to the Service, the error was treated as never having occurred for tax purposes and, hence, the potential tax liability that policyholders of such contracts faced due to the failure of their contracts to comply with section 7702 was eliminated. These rulings also informed the life insurance industry of the Service's then-applicable position with respect to QABs. Given the non-precedential status of the private rulings, however, many companies were presented with the difficult task of either conforming to the Service's view as thus expressed, which in many cases would entail very substantial costs, such as in modifying compliance systems, or choosing to ignore the rulings and run the risk of additional contract failures and increasing tax exposure.

The Ruling

The Ruling holds that the reasonable expense charge rule of section 7702(c)(3)(B)(ii) applies to charges for QABs. This is not surprising, given the Service's position in the private rulings just described. By publishing this position in a revenue ruling, however, the Service now has accorded it precedential weight with respect to all taxpayers. Perhaps more importantly, the Ruling provides relief to life insurance companies who previously concluded that the reasonable mortality charge rule, rather than the reasonable expense charge rule, governed the treatment of QABs. This relief comes in the form of special rules and procedures for entering into a closing agreement with the Service.

continued 16

from pg. 15

The Ruling's grant of relief for those who previously applied the rules incorrectly (in the Service's view) recognizes that the normally applicable procedures for addressing errors under sections 7702 and 7702A would not produce an equitable result in the present circumstances. Under the Service's generally applicable procedures, life insurance contracts failing to comply with section 7702 or section 7702A can only be brought into compliance through a proceeding with the Service, i.e., receipt of a waiver under section 7702(f)(8) or execution of a closing agreement covering failures to comply with section 7702, and execution of a closing agreement covering inadvertent MECs. Under each of these procedures, it is generally necessary to correct systems and contracts so that the error causing the failures is corrected. For example, for a contract failing under the GP test, correction often takes the form of returning premiums in excess of the properly determined guideline premium limitation. Also, in the case of closing agreements, it is often necessary to pay a significant "toll charge." In the case of closing agreements under section 7702, for instance, the toll charge is intended to serve as a proxy for the federal income taxes that owners of the failed life insurance contracts would have paid if they had included the income on the failed contracts (as defined by section 7702(g)) in their income. Deficiency interest also is payable as part of the toll charge.

The Ruling's special rules and procedures deviate from the normal procedures in two significant respects. First, they do not require a life insurance company to take corrective actions with respect to QABs that have been accounted for using the reasonable mortality charge rule, if the issuer requests relief through a closing agreement before Feb. 7, 2006. Second, a special toll charge structure is adopted which generally involves much reduced costs compared with those otherwise applicable. Under the special toll charge structure, the charge is determined under a sliding scale based upon the aggregate number of contracts for which relief is requested. The same special toll charge structure applies regardless of whether the failure is under section 7702, section 7702A, or both.

The Ruling's relief provisions are set forth in the "Application" part of the Ruling, which is divided into three separate alternatives—A, B and C. The remainder of this discussion details the specifics of the relief provided by the Ruling.

Alternative "A." The first alternative of the Application part of the Ruling states that, where an issuer's compliance system improperly accounts for QAB charges but no contracts have failed under section 7702, the issuer may correct its system to account for charges using the reasonable expense charge rule without any need to contact the Service. It appears that this alternative is simply a restatement of actions that issuers may take under existing law. Thus, the alternative serves as a reminder to life insurance companies that they do not need to involve the Service in the circumstance where no contracts have failed to meet the definitional tests of sections 7702 and 7702A. At the same time, the alternative does not provide any relief, in and of itself, since the determination that no contracts fail must be made using the reasonable expense charge rule for QABs, and thus this alternative contemplates correction of compliance systems.

Alternative "B." The second alternative of the Application part of the Ruling states that, where an issuer's compliance system improperly accounts for QAB charges and, as a result, some contracts do not meet the definition of life insurance contract under section 7702(a), the issuer may request a closing agreement on or before Feb. 7, 2006 on the basis described below. While this alternative's introductory language refers to contracts that do not meet the definition of life insurance under section 7702(a), it seems clear from the remainder of the discussion under this alternative that the intent was for the relief provided also to be available for inadvertent MECs under section 7702A, even though such contracts are in compliance with section 7702. In addition, the relief provided is not by its terms limited to any particular types of QABs, i.e., all are encompassed, or to particular determinations under sections 7702 or 7702A, i.e., errors under the GP test, the CVA test and the 7-pay test are all encompassed.

Under a closing agreement entered into pursuant to this Alternative B:

(1) The issuer must identify all contracts administered under the compliance system, but need not identify whether they fail under section 7702 or section 7702A. The Ruling does not state the precise manner in which such identification must be made. Under closing agreements addressing section 7702 failures in other contexts, policy numbers are used to identify contracts.

(2) The identified contracts will not be treated as failing under section 7702 or as inadvertent MECs under section 7702A by reason of improperly accounting for charges for existing QABs. This relief will extend to future charges resulting from an increase in an existing QAB or the addition of a new QAB pursuant to the exercise of a right that existed in the contract before April 8, 2005. However, the relief under the closing agreement will not extend to improper accounting for charges for an increase in an existing QAB, or the addition of a new QAB, that are not pursuant to the exercise of a right that existed in the contract before that date.

While there is some uncertainty on the point, the Ruling appears to allow inclusion of contracts issued on and after April 8, 2005, as long as the request for relief identifying such contracts is made before February 7, 2006. If this is correct, the availability of relief for such contracts allows issuers a transition period in which they may continue marketing their products while modifying systems (and perhaps policy forms) to apply the reasonable expense charge rule to QABs under new contracts. In addition, while the denial of relief for increases in and additions of QABs was perhaps a reasonable exception for the Service to adopt (since, absent such an exception, such changes to an existing contract's QABs could be motivated by a desire to obtain the benefit of such relief), no such exception is necessary for newly issued contracts. It is very unlikely that the prospective purchaser of a new contract would be motivated by the presence or absence of transition relief pertaining to use of the reasonable expense charge rule for QABs.

(3) No corrective action need be taken with respect to the compliance system or with respect to contracts identified in the closing agreement. To the extent the compliance system will be used to administer newly issued contracts, such system will of course need to apply the reasonable expense charge rule. As discussed above, at the latest, contracts issued on and after February 7, 2006 would need to be administered in accordance with the reasonable expense charge rule.

(4) In lieu of the amount of tax and interest that would be owed by the policyholders under a normal section 7702 or section 7702A closing agreement, the amount due under a closing agreement under this Alternative B will be based on a schedule contained in the Ruling that sets forth a sliding scale of charges keyed to the "number of contracts for which relief is requested." This scale ranges from $1,500 for 20 contracts or fewer, to $50,000 for over 10,000 contracts.

When the Ruling states that the sliding scale charge will be based on the "number of contracts for which relief is requested," its statement seemingly is intended to correspond to the requirement of paragraph (1) on page 16, which states that "the issuer must identify all contracts administered under the compliance system." Thus, the number so identified would be the same number for which relief is requested. There are several points of uncertainty, however, regarding the manner in which the toll charge is calculated.

For example, is it permissible for an issuer to include all contracts that it has administered improperly and for which it was responsible, regardless of whether such contracts were originally issued by the company? Given that the insurance industry has undergone considerable merger and acquisition activity in recent years, in efforts to promote greater efficiencies, in many cases an insurance company and its affiliates administer and are responsible for the tax compliance of contracts originally issued by other insurers (in some cases many other issuers). Application of the $50,000 cap for all such contracts would seem appropriate, although the Ruling is not clear on this point.

As another example of uncertainty, consider the situation where a company wants to apply the reasonable expense charge rule retroactively to all of its in-force contracts, perhaps because of systems considerations, and then obtain relief only for contracts that fail to comply with section 7702. The company presumably could request a private letter ruling from the Service seeking waivers for the errors. Such action would be consistent with the four private letter rulings that already have been issued by the Service, and the Ruling itself, and in particular its analysis and provision of relief, lends additional support for the view that errors in

continued 18

from pg. 17

accounting for QABs under section 7702 are "reasonable errors," an essential element of entitlement to waiver relief under section 7702(f)(8). If the company wanted instead to utilize Alternative B of the Ruling, is it available in this circumstance, and in what manner? (We comment on this question as part of the discussion of Alternative C below.)

(5) The request for a closing agreement must be submitted with the user fee required by applicable procedures governing requests for private letter rulings (generally $7,000 for 2005).

Alternative "C." The third and final alternative of the Application part of the Ruling states that after Feb. 7, 2006, an issuer whose compliance system improperly accounts for QAB charges may request a closing agreement under the same terms and conditions as described under Alternative B on (page 16), except that (1) the closing agreement must identify the contracts that fail to satisfy the requirements of section 7702 or are inadvertent MECs under section 7702A, and (2) the closing agreement must require the issuer to correct its compliance system and to bring the identified contracts into compliance with section 7702 or section 7702A, as applicable.

The Ruling is silent regarding the effect of the Ruling on the existing waiver request process under section 7702(f)(8). The Ruling does not state that waivers are no longer available, e.g., there is no provision in the Ruling stating that it sets forth the exclusive means for addressing errors in accounting for QABs. Also, as noted above, the Ruling's analysis and relief implicitly recognize the reasonableness of this type of error. The presence of Alternative C, however, given its requirement of correcting failed contracts and the need to pay the sliding scale toll charge, may imply that errors in accounting for QABs will not be viewed as reasonable errors beginning at some time in the future (possibly after Feb. 7, 2006, the effective date for use of Alternative C), rendering waivers unavailable.

It is clear that the number of contracts actually failing the statutory tests, rather than the number administered on the compliance system, is intended to be used to determine the sliding scale toll charge under Alternative C. As discussed above, some issuers may want to apply the reasonable expense charge rule retroactively and seek relief under the Ruling (and calculation of the sliding scale toll charge) only for failed contracts. Alternative C permits this, but only for requests made after Feb. 7, 2006. If the issuer wants to make the request sooner, it may be possible to do so under Alternative B and simply identify the failed contracts. While Alternative B requires identification of "all contracts administered under the compliance system" and payment of a toll charge based on "the aggregate number of contracts for which relief is requested," it seems reasonable that the Service would allow identification of, and payment of the toll charge with regard to only the failed contracts under this alternative in circumstances where the issuer is not seeking any relief for any other contracts. Such an interpretation not only would reconcile Alternatives B and C, but would also be consistent with the principles underlying Alternative A, i.e., that there is no need to involve the Service for contracts that comply (based on retroactive application of the reasonable expense charge rule) and will be administered in accordance with the correct rule on an ongoing basis.

Conclusion

The Ruling represents a positive and reasonable resolution of a significant problem faced by many life insurers due to the uncertainty as to whether QABs should be accounted for under the reasonable expense charge rule or the reasonable mortality charge rule described in section 7702. By providing procedures which avoid retroactive application of new guidance in light of equitable considerations, and under which life insurance companies are required to pay only a reduced toll charge, the Service has provided a reasonable and workable form of relief.

Life insurance companies should review their treatment of QAB charges, and if their treatment differs from the position ultimately adopted by the Service in the Ruling, determine which of the Alternatives above is the most prudent for them.

The Service and U.S. Treasury Department are to be commended for their thoughtful consideration of this matter, and hopefully the Ruling will serve as a model for future action as and when similar situations arise.