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» contents

Private Rulings Regarding
"Cash Surrender Value"
Under Section 7702

by Craig R. Springfield and Brian G. King

Last year the Internal Revenue Service (IRS) issued two private letter rulings, PLR 200521009 (May 27, 2005) and PLR 200528018 (July 15, 2005), that involved the meaning of the term "cash surrender value" as used in section 7702 of the Internal Revenue Code, which sets forth the federal tax definition of "life insurance contract." In these rulings, the life insurance contracts provided for payment of a "remittance" upon surrender of a contract that was in addition to the generally applicable policy value payable upon surrender. The IRS concluded that the remittances represented "cash surrender value" within the meaning of section 7702(f)(2)(A) and further concluded that the failure of the taxpayers to reflect the remittances as cash surrender value was a reasonable error under section 7702(f)(8).

Facts Involved in the Rulings

The contracts involved in one of the rulings were designed to comply either with the cash value accumulation test of section 7702(b) (CVAT) or the guideline premium limitation (GPL) and cash value corridor (CVC) tests of section 7702(c) and (d). In the other ruling, all of the contracts were designed to comply with the CVAT.

The contracts involved in the rulings provided a policy value that was available upon surrender – referred to in one of the rulings as the "Account Value" and in the other ruling as the "Accumulation Value." The remittance was not part of this policy value. Rather, the remittance was an additional amount payable

upon the early surrender of a contract. (The rulings do not explain what was meant by "early" surrenders.) In one of the rulings, the remittance was defined as a percentage of premiums paid for the contract, and the specific percentage applicable depended upon when the surrender occurred and how much premium had been paid relative to the target premium for the contract. Part of the remittance was guaranteed from issuance, but the insurance company also paid certain non-guaranteed remittance amounts. In the other ruling, the remittance was defined as a percentage of certain charges assessed and depended upon when the surrender occurred.

In both of the rulings, no portion of the remittance could be borrowed against by the contract owner.

"Cash Surrender Value" Under
Section 7702

Section 7702(f)(2)(A) defines cash surrender value for purposes of section 7702 as a contract's "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." The code does not elaborate on the meaning of the term "cash value" as used to define cash surrender value in section 7702(f)(2)(A). Moreover, there are no final or temporary regulations providing guidance on the meaning of these terms, nor have any revenue rulings or other precedential guidance been published regarding their meaning under section 7702.

continued → 4

Private Rulings Regarding "Cash Surrender Value" Under Section 7702 <i>Craig R. Springfield and Brian G. King</i> _____	1
From the Editor <i>Brian G. King</i> _____	2
From the Chair <i>Barbara R. Gold</i> _____	3
Highlights of the Recent Guidance on Insurance Company Acquisitions <i>Mark H. Kovey and Lori J. Jones</i> _____	9
The Statutory Reserve Cap on Tax Reserves Includes Deficiency Reserves <i>Samuel A. Mitchell and Peter H. Winslow</i> _____	14
Removal of Profit/Loss Separation Rule from Life/Nonlife Regulations Eliminates Tax Issue from Securitizing Triple-X Business <i>Michael A. Bell</i> _____	18
The IRS Schedule M-3 for Insurance Companies <i>Amy C. Lewis</i> _____	22
When Are Guaranty Association Assessments Deductible? <i>Peter H. Winslow and Lori J. Jones</i> _____	24
T3: <i>Taxing Times</i> Tidbits _____	26
Book Review <i>Greg Stephenson</i> _____	29

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The lack of authoritative guidance is perhaps indicative of the fundamental nature of the term, given the various contexts in which the notion of a life insurance contract’s cash value is important (for tax purposes and otherwise) and given product designs that vary in the mechanisms they employ with respect to making cash payments available prior to an insured’s death. Nonetheless, properly identifying a contract’s cash value and cash surrender value within the meaning of section 7702(f)(2)(A) is of critical importance for purposes of complying with the CVAT, since this test requires that, by a contract’s terms, the cash surrender value must not at any time exceed the net single premium applicable under the contract at that time. This term is similarly important to satisfaction of the CVC, which requires the death benefit under a contract to be at least a certain percentage, varying by age, of the contract’s cash surrender value.

The IRS’s Analysis

The IRS’s analysis as set forth in the above private rulings began with a discussion of the common meaning of cash surrender value and cash value as described in certain insurance texts. One such text defined the term cash surrender value as “the amount made available contractually, to a withdrawing policyowner who is terminating his or her protection.” Kenneth Black, Jr. & Harold D. Skipper, Jr., *Life & Health Insurance* 46 (13th ed. 2000) (“Black & Skipper”). Another cited text defined cash value as the “amount available to the policyholder upon the surrender of the life insurance contract.” John H. Magee, *Life Insurance* 599 (3rd ed. 1958).

It is noteworthy that Black & Skipper provides additional commentary regarding the meaning of cash surrender value that, while not cited by the IRS, may be relevant in defining this term under section 7702. Specifically, Black & Skipper, at p. 993, describe cash surrender value as “[t]he amount of prefunded mortality charges that is available to a terminating policyowner.” In other words, the cash surrender value of a contract at any time is the dollar amount under the contract accumulated to pay for insurance coverage to be provided in future years. In the context of universal life insurance policies, this value often is the contract’s policy value (or other similar term, such as account value or accumulation value as in the private rulings). This interpretation is supported by the additional observations in Black & Skipper, at p. 235, that –

Cash-value policies may be surrendered for their net surrender value The available net surrender value is the gross cash value shown in the policy, decreased by any surrender charges ... and the amount of any policy loans outstanding, and increased by the cash value of any paid-up additions, any dividends accumulated at interest, and any prepaid premiums.

Applying this language to a universal life insurance contract, the cash value for which a contract may be surrendered is its policy value reduced by surrender charges and policy indebtedness. Section 7702(f)(2), however, disregards surrender charges and policy indebtedness (i.e., they are not netted against a contract’s cash value), and thus the contract’s policy value, or “gross cash value” to use Black & Skipper’s term, is the amount that constitutes its cash surrender value for purposes of section 7702.

The IRS next cited the legislative history of section 7702, which provides that “cash surrender value” is defined in the bill as “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.” S. Print No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984). The IRS did not elaborate upon this legislative history description, but it is noteworthy that this passage, while largely following the statutory language, provides insight regarding Congress’ understanding of the term “cash value” as used in the definition of cash surrender value—*i.e.*, that cash value is the amount available “upon surrender *and* against which the policyholder can borrow.” (Emphasis added.)

The IRS finally discussed the 1992 proposed income tax regulations (never finalized) defining cash value which provide that this term generally equals the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow under the contract. See 57 Fed. Reg. 59319 (Dec. 15, 1992). While not noted by the IRS, these proposed regulations further provide that the term cash value does not include (1) the amount of any death benefit (as defined in the proposed regulations), (2) the amount of any qualified additional benefit, (3) the amount of certain benefits payable upon the occurrence of a morbidity risk, (4) an amount returned to the

insured upon termination of a credit life insurance contract due to a full repayment of the debt covered by the contract, or (5) a reasonable termination dividend not in excess of \$35 for each \$1,000 of the face amount of the contract. See Prop. Treas. Reg. section 1.7702-2(b)(2).

As recognized by the IRS later in the private rulings, the proposed regulations are materially different from the legislative history noted above with respect to the treatment of amounts subject to borrowing. Specifically, use of the operative word “and” in the above legislative history appears to contemplate that an amount must be subject to borrowing in order to be considered a cash value. In contrast, use of the operative word “or” in the proposed regulations appears to contemplate the opposite—*i.e.*, that an amount does not need to be subject to borrowing in order to constitute part of a contract’s cash surrender value. The interpretation based on the legislative history—that an amount must be subject to borrowing in order to be a cash value—is bolstered by a later passage in this history which provides that the amount payable upon certain terminations of credit life insurance contracts “will not be considered part of any cash surrender value *because*, generally, such amount is not subject to borrowing under the policy.” (Emphasis added.) S. Print. No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984).

The IRS did not cite the Joint Committee on Taxation’s Bluebook explanation on this point, which is phrased slightly different from the official legislative history. Specifically, it identifies cash value as “any amount to which the policyholder is entitled upon surrender and, generally, against which the policyholder can borrow.” Staff of the J. Comm. on Tax’n, 98th Cong., General Explanation of the Deficit Reduction Act of 1984, at 647 (Comm. Print 1984).

Based on the above analysis, the IRS concluded that the remittances constituted part of the cash surrender value of the contracts, thus causing contracts designed to comply with the CVAT to fail this test. In addressing whether the company’s error of not treating the remittances as cash value was a waivable error under section 7702(f)(8), the IRS noted that, under Notice 93-37, 1993-2 C.B. 331, the effective date of the proposed regulations would be no earlier than the date of publication of final regulations in the Federal Register

The more important question remains, however, regarding how companies construe the meaning of cash surrender value under current law.

(which has not yet occurred). The IRS then observed that the proposed regulations do not contain language that is identical to the definition of cash surrender value in the legislative history of section 7702. For these reasons, the IRS concluded that the error was waivable in both of the private rulings.

Implications of the Rulings

The current state of the law regarding the meaning of cash surrender value under section 7702 is unclear at the present time, given the paucity of guidance contained in the statute and legislative history and the 13 years during which we have been living with proposed regulations that have not been finalized or issued in temporary form. This uncertainty in the law, together with Notice 93-37, appears to have been significant to the IRS’s granting of relief under the waiver provision of section 7702(f)(8).

The more important question remains, however, regarding how companies should construe the meaning of cash surrender value under current law. Significantly, the holdings of the private rulings appear *to not* follow the official legislative history of section 7702 (as the IRS seems to have recognized), and instead appear more in line with the proposed regulations that are not yet effective. Also, the stakes involved are very material. In the case of contracts designed to comply with the CVAT especially, given that the terms of the contract must ensure compliance with the test at all times, even minor errors in accurately identifying cash value can result in non-compliance with this test.

Characteristics of the remittances that were important While private rulings are not precedential, the IRS’s current views regarding the meaning of cash surrender value under section 7702 can in some respects be identified from the characteristics of the remittances addressed by the rulings. First, the IRS looked to the meaning of cash value under state law

continued → 6

and appears to have interpreted such law as more broadly defining cash value than the policy values of the contracts in the private rulings. This point is important to bear in mind since contract design and administrative systems usually focus on policy values, and rarely do insurers look beyond the policy value to ascertain a contract's cash surrender value for purposes of section 7702. Examining the meaning of cash value as traditionally interpreted under state insurance law is entirely appropriate, given that the meaning of this term under such law at the time of section 7702's enactment arguably is highly relevant to understanding the proper meaning of the term. Some might argue, however, that in the context of the facts of the rulings, this value was exclusively represented by the contracts' policy values. (See, for example, the discussion above regarding passages from Black & Skipper not discussed in the rulings.) The IRS, however, appears to have given substantial weight to the fact that the remittances would increase the amount payable upon a surrender, and the nature of such payments and their function within the contract seemingly were given lesser weight. In this regard, while the remittances were not, in fact, termination dividends (which generally are excluded from cash surrender value under the statute), in some respects such amounts are analogous to such dividends.

A second feature of the remittances that provides insight into the IRS's views regards the fact that such amounts were only payable for limited durations, *i.e.*, in connection with “early” surrenders. In other words, it appears that the remittances were available for a temporary period, and then they vanished and had no continuing effect on the contracts. In this respect, the remittances arguably could have been characterized as pertaining to a rescission of a contract but not as amounts that constitute cash value. While the timeframes are not identified in the rulings, the presence of amounts of a rescissory

nature under life insurance contracts, and the need to exclude such amounts from cash value, is not unique to the contracts addressed by the rulings. Perhaps the strongest case could be made for return of premium benefits payable during the free-look period of a contract. These benefits return the premiums that have been paid, including any charges that have been assessed. Such returns of charges arguably are very similar to the remittances. At the same time, most would say that it is “stating the obvious” to conclude that free look amounts are not part of a contract's cash value for section 7702 purposes. Where the IRS would draw the line between such amounts and the remittances is unclear, and not addressed by any guidance.

The temporary period during which the remittances were available appears to be a very relevant consideration to whether such amounts constitute cash surrender value in light of the legislative intent underlying the enactment of section 7702 of constraining the investment orientation of life insurance contracts. See S. Print No. 98-169, at 572 (1984); H.R. Rep. No. 98-432, at 1443 (1984). On the one hand, the presence of an additional amount available on surrender lessens the net amount at risk to the insurer, *i.e.*, the pure insurance element, involved with the death benefit, and correspondingly an insurer generally would need to charge less for coverage than would be the case absent the additional amount payable on a surrender. Thus, the presence of any additional amount payable on a surrender arguably increases investment orientation, since the return on investment possible in connection with a surrender is higher due to the lower net amount at risk. On the other hand, if the remittances only applied for a relatively limited duration and did not later affect the policy values of the contracts (as appears to be the case), it seems questionable to view the remittances as increasing the contracts' investment orientation.

A third feature of the remittances adds to the lack of investment orientation associated with these amounts: the apparent lack of any interest or gains, *i.e.*, inside build-up, that were ever credited to the remittances. Since section 7702 is concerned about excessive investment orientation, one can reasonably ask whether this concern is materially present in the first instance with respect to amounts on which no inside build-up accrues. While, as noted above, the IRS could argue that all amounts payable on surrender reduce net amount at risk, and thus the net amount at risk to the company for which cost of



insurance charges need to be assessed, this concern would seem limited with respect to amounts payable on which no inside-build-up accrues. As a practical consideration, the potential that net amount at risk would ever be materially diminished under a life insurance contract by amounts on which no investment return is available seems unlikely since, to the extent such amounts truly are in the nature of cash value, policyholders will demand an appropriate return with respect to such investment.

Ramifications for calculations under section 7702 and 7702A

In the private rulings, the principal focus was on whether the remittances constituted part of the cash surrender value of the contracts. A conclusion that an amount constitutes cash-surrender value may have an additional consequence under sections 7702 and 7702A that should be considered as well. Specifically, if an amount constitutes cash value and is provided on a guaranteed basis, does this affect the guarantees under a contract that are taken into account in calculating guideline premiums, net single premiums, and seven-pay premiums under these statutes? The presence of an additional guaranteed cash value arguably could be viewed as resulting in an increased interest rate guarantee in certain circumstances. In addition, if the additional cash value returns to the policyowner certain expenses that have been charged, this may imply that such expenses are so contingent that they should not be taken into account in calculating guideline premiums in the first instance.

Conforming Changes Permitted

Notice 93-37, which as noted above announced that the effective date of the proposed regulations under section 7702 would be no earlier than the date of publication of final regulations in the Federal Register, also outlined a relief provision that was anticipated for the final regulations. Specifically, the notice states that “it is anticipated that insurance companies generally will be allowed a period of time after final regulations are published to bring their policy forms into compliance with any new rules.” It is unclear whether this reference to “policy forms” was intended to include in-force policies or the forms that insurers use to issue policies. It should be construed to encompass both.

It is interesting to note, however, that the cited passage refers to “putative cash surrender value,” and this reference arguably is viewing a contract’s putative amount, i.e., its policy value, as being the same as its cash surrender value.

Legislative History Relating to Cash Surrender Value under Section 7702A

In connection with explaining certain amendments to section 7702A made in 2002, the Joint Committee on Taxation commented that the definition of cash surrender value under the so-called “rollover rule” of section 7702A(c)(3)(ii) was, by cross-reference, the same as that in section 7702. The Joint Committee then stated that, for purposes of applying this rule, “it is intended that the fair market value of the contract be used as the cash surrender value under this provision, if the amount of the putative cash surrender value of the contract is artificially depressed.” Staff of the J. Comm. on Tax’n, 107th Cong., Technical Explanation of the “Job Creation and Worker Assistance Act of 2002” (Comm. Print 2002). This legislative history seems to have little relevance for purposes of generally defining cash surrender value, since it appears to function solely as an anti-abuse rule directed at limited situations. It is interesting to note, however, that the cited passage refers to “putative cash surrender value,” and this reference arguably is viewing a contract’s putative amount, i.e., its policy value, as being the same as its cash surrender value.

Concluding Thoughts

The IRS’s holdings in the private rulings are consistent with the 1992 proposed regulations, even though such regulations are not currently effective. In this regard, the framework of these regulations is that all amounts payable upon a surrender are includible in cash surrender value unless they are covered by one of the listed exclusions. When the IRS issued the proposed regulations, comment letters from taxpayers emphasized that the proposed definition of cash surrender value was overly broad, and that if the structure of the regulations was retained it would be necessary for numerous

continued → 8

additional exclusions to be incorporated into the regulations. Of particular relevance to the private rulings, the American Council of Life Insurers in its comments proposed, *inter alia*, that any “pro-rata portion of a periodic premium payable on contract termination or *any pro-rata refund of charges assessed in advance under the contract*” be specifically excluded from cash surrender value (emphasis added). The private rulings show, non-precedentially, that the IRS disagrees with respect to the appropriateness of this requested exclusion, at least under the facts set forth in the rulings.

In the absence of final regulations or other published guidance, we are left with considerable uncertainty regarding the meaning of cash surrender value in circumstances where benefits or contract provisions entail cash payments upon a surrender beyond the putative cash value represented by a contract’s policy value (or other similar term that might be used). In situations where a contract includes such payments, careful analysis should be undertaken to determine whether it should be included in cash surrender value, rather than simply assuming that the policy value equates to the cash-surrender value.

One open question regards how the relief provided by Notice 93-37—allowing insurers to conform to final regulations—will be accomplished. If final regulations were issued, a procedure could be established to address this question. In the absence of final regulations, it seems that making a request for a private ruling (*e.g.*, an affirmative ruling that an amount is not a cash surrender value and possibly a request for waivers should the IRS disagree) is the only avenue currently available to obtain certainty with respect to the tax treatment of such amounts. For many, the best practical choice will be to simply adopt a conservative position, *i.e.*, view amounts in question as cash surrender value even though good arguments might be made to the contrary. However, this likely would not be a viable alternative for many. In light of the importance of this definitional question, a better solution may be for the IRS to consider the issuance of formal guidance reflective of the dictates of the statute, legislative intent, and due consideration of industry comments. ◀

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