

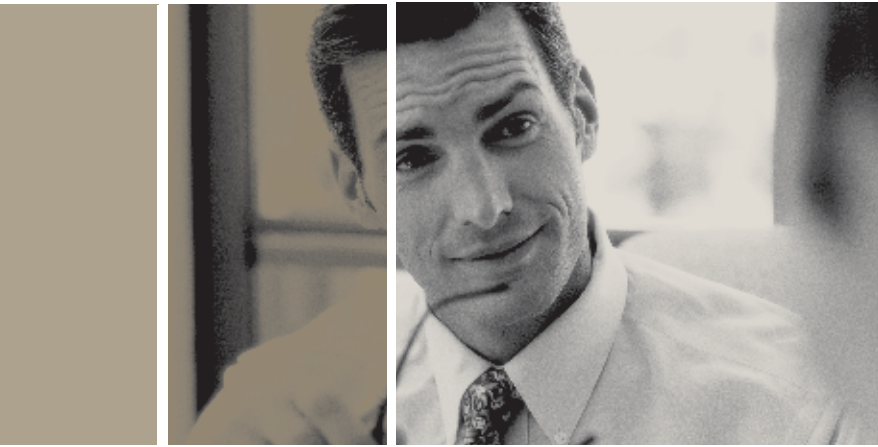


SOCIETY OF ACTUARIES

Article from:

# Taxing Times

May 2011 – Volume 7 Issue 2



# THE IRS RULES ON SECTION 7702 ISSUES REGARDING A GUARANTEED DISTRIBUTION RIDER

By Brian G. King

In the fall of 2010, the Internal Revenue Service (IRS) issued a private letter ruling (PLR 201046008) to a taxpayer offering a rider for a variable life insurance contract that provides a minimum annual withdrawal or loan amount, irrespective of the investment performance underlying the accumulation account of the contract (the “Rider”). While the IRS has ruled on guaranteed minimum withdrawal benefits (GMWB) associated with a variable deferred annuity contract, this is the first time the IRS has provided a ruling for this type of product. While similar in concept, there are a number of relevant factors described in the ruling that distinguish the Rider from a typical GMWB on a deferred annuity: 1) the Rider is associated with a life insurance contract; 2) the form of the distribution can vary between a withdrawal and a policy loan; and 3) the policyholder has the ability to alter both the timing and magnitude of the benefit payable under the Rider (unlike a typical GMWB which is generally fixed both in terms of timing and magnitude).

The taxpayer submitting the ruling request asked the IRS to rule on two particular aspects of the contract. The first ruling deals with the proper determination of the cash surrender value under section 7702(f)(2)(A). While similar in certain regards to the private letter rulings the IRS has issued over the past several years dealing with the section 7702(f)(2)(A) definition of the cash surrender value,<sup>1</sup> this ruling provided little in the way of discussion or analysis that would provide further insight into the IRS views on the definition of cash surrender value. The ruling simply confirmed that the taxpayer properly defined cash value in a manner that is consistent with the section 7702(f)(2)(A) definition of cash surrender value.

The second ruling request focused on the effect that the Rider has on the calculation of the net single premium under the cash value accumulation test (CVAT) or the guideline premium limitation. Like the first request, there was little in the way of analysis provided in the ruling to support the conclusion reached by the IRS, that the calculation of the net single premium and the guideline premium limitation were unaffected by the presence of the Rider.

## FACTS OF THE RULING

The ruling request provides a rather detailed description of the characteristics of the Rider and the life insurance contracts to which the Rider will be attached. The life insurance contracts are flexible premium variable life insurance contracts (the “Policies”) and have features that are consistent with flexible premium variable life insurance contracts available in the market today. The Policies provide for a policy value to which premiums are allocated and interest (or other investment earnings) is credited, and from which certain expense, cost of insurance and other charges are deducted. Policyholders can borrow against the policy value and can elect to receive withdrawals of a portion of the net cash surrender value, or NCSV (*i.e.*, the policy value less surrender charges and outstanding policy loans). In addition, a policyholder can choose between two variations of the Policies, one designed to comply with the guideline premium limitation and cash value corridor (CVC) test of section 7702(a)(2) and another designed to comply with the cash value accumulation test CVAT of section 7702(a)(1).

The Rider is funded by a monthly charge that is assessed against the Policy’s cash value. The taxpayer submitting the ruling represents that the Rider and any benefits payable under the Rider are part of the Policies for state law purposes and are not regulated or otherwise treated under state law as an annuity contract or as some other type of non-life insurance contract. Under this view, the charges assessed against the Policy’s cash value would not be considered distributions, and would be treated similar to contractual expense or cost of insurance charges. Because the Rider does not meet the section 7702(f)(5) definition of a qualified additional benefit, Rider charges assessed against the Policy’s cash value would likely be characterized as distribution (and potentially taxable) if the Rider was considered an additional benefit and not an integrated part of the Policy.

The ruling request describes a number of conditions (“Rider Conditions”) that must be satisfied in order for the policyholder to be eligible for the Rider to remain in force. If the policyholder follows the Rider Conditions, the policyholder

will be entitled to the “Annual Rider Benefit,” which is the maximum amount that is available for distribution each year during the “Rider Benefit Period.” The Rider Benefit Period defines the date on which the policyholder becomes entitled to distributions under the Rider and the number of years over which benefits are payable. Distributions paid under the Rider can take the form of withdrawals or loans, although the ruling does not provide details describing when distributions are received as withdrawals or loans. If the NCSV is insufficient to make a distribution, the policy value would be increased by the excess of the amount of the distribution requested (but not more than the Annual Rider Benefit) over the NCSV. The Rider would therefore infuse cash into the policy value so that the NCSV would have sufficient value to make the distribution (loan or withdrawal) provided under the Rider.

In addition to providing the Annual Rider Benefit, the Rider also guarantees the policy will not lapse if the Rider Conditions are satisfied (*i.e.*, a no lapse guarantee). Accordingly, if the policy value is reduced because of losses in the variable accounts, and is insufficient to fund cost of insurance or other charges under the Policy, the no lapse guarantee will keep the policy in force.

The ruling goes on to describe how the Policies define the minimum death benefit. The Policies’ minimum death benefit, without regard to the Rider, equals the product of 1) the applicable minimum death benefit factor (varies based on age and whether the policy is intended to meet the CVAT or the CVC test) and 2) the policy value. If the Rider is present, during the Rider Benefit Period, the minimum death benefit is calculated by multiplying 1) the applicable minimum death benefit factor by 2) the greater of a) the policy value and b) the Annual Rider Benefit. Under this definition, the Annual Rider Benefit would be considered section 7702(f)(2)(A) cash surrender value to the extent it exceeds the policy value.

### RULING REQUEST NUMBER ONE

The first ruling request deals with the section 7702(f)(2)(A) definition of cash value. Because the Rider operates in a manner that can infuse money into the policy value, the taxpayer was seeking assurances that it was properly accounted for in defining the minimum death benefit required of section 7702. This would be of particular importance for contracts designed to comply with the CVAT, which must be satisfied by contract terms. Several private letter rulings dealing with the definition of cash surrender value have been issued over the past several

years. These rulings all focused on life insurance products that provided for amounts available upon surrender that were in excess of what is generally viewed to be the accumulation account in a universal life type insurance contract. These rulings were the subject of two *TAXING TIMES* articles published in 2006 and 2009<sup>2</sup> (the “Prior *TAXING TIMES* Articles”). It is likely that these rulings prompted the taxpayer to seek a ruling request on this product.

Because the cash surrender value is a necessary element for determining the minimum required death benefit, it is important that it be properly defined in the contract. By defining cash surrender value as the greater of the policy value and the Annual Rider Benefit, the Policies take into account the greatest amount that the Rider can increase the policy value at any one time.

Based on the facts presented in the ruling request, it appears that the form of the distribution will impact the effect that the Rider can have on the policy value, which in turn affects the minimum required death benefit. When the Rider Benefit is payable as a policy loan, the Rider will increase the policy value to the extent the NCSV is less than the Annual Rider Benefit. Since the loan will not reduce the policy value (it will reduce the NCSV), any infusion of cash from the Rider would be reflected in the determination of the minimum required death benefit directly through the increase in the policy value.

Alternatively, if the Rider Benefit is payable as a withdrawal, the Rider will increase the policy value to the extent the NCSV is less than the Annual Rider Benefit. When the withdrawal occurs, both the policy value and the NCSV would be reduced accordingly. It would seem that only when the policy value and the NCSV are the same (or approximately the same), that the Annual Rider Benefit could exceed the policy value. When this occurs, the minimum required death benefit would be defined in terms of the Annual Rider Benefit.

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If the NCSV is insufficient to make a distribution, the policy value would be increased by the excess of the amount of the distribution requested (but not more than the Annual Rider Benefit) over the NCSV.

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The taxpayer has taken the position that the infusion of cash from the Rider can create cash surrender value in certain instances for purpose of section 7702(f)(2)(A), either directly through the increase in the policy value in the event the Rider Benefit is payable as a policy loan, or indirectly to the extent the Rider Benefit is payable in the form of a withdrawal. It is worth noting that both the taxpayer and the IRS relied on the definition of cash surrender value contained in a 1992 proposed regulation.<sup>3</sup> For a detailed analysis of the available guidance regarding the definition of cash value, including a description of definition of cash value contained in the 1992 proposed regulation, refer to the Prior *TAXING TIMES* Articles. While somewhat controversial on its reliance on a regulation that is currently in proposed form and is subject to a rule rendering it currently inapplicable (*i.e.*, IRS Notice 93-37), the ruling provided very little in the way of analysis of this issue, perhaps due to the fact the taxpayer adopted a definition of cash surrender value that was consistent with its position in the prior rulings.<sup>4</sup>

### RULING REQUEST NUMBER TWO

The second request in the ruling addresses the effect of the Rider on the calculation of net single premiums and guideline premiums, presumably in the at issue calculation and on the later occurrence when the rider infuses cash into the policy value. The IRS seemed to focus on whether the operation of the Rider would trigger an adjustment event, presumably resulting from the increase in the policy value when the NCSV was insufficient to provide the Annual Rider Benefit. The analysis contained in the ruling notes that 1) the factual circumstances underlying the operation of the Rider are not those described in the legislative history describing the changes in future benefits that require an adjustment and 2) that upon issuance of the contract, it is not known if and when the Rider will ever operate to increase the cash value. Based on this analysis, the IRS concluded that the calculation of net single premiums or guideline premiums is unaffected by the Rider.

### CONCLUSION

The discussion of the issues in the ruling is limited, including only a restatement of the IRS's view of cash surrender value and a comment that "the factual circumstances here are not those described by the DEFRA Bluebook's discussion of a change in future benefits that require an adjustment."<sup>5</sup> While providing some useful insights into the IRS's view on the section 7702 requirements regarding guaranteed distribution riders, the IRS continues to show reliance on the 1992 Proposed

Regulations defining cash value. Now that formal guidance on the section 7702 definition of cash value has made its way on to the IRS Priority Guidance Plan for 2010-2011, clarity may finally be shed on the ongoing controversy regarding the definition of cash value. ◀

#### END NOTES

- <sup>1</sup> See PLR 200521009 (Feb. 22, 2005), PLR 200528018 (April 12, 2005), PLR 200841034 (March 28, 2008) and PLR 200901028 (Sept. 29, 2008).
- <sup>2</sup> Craig R. Springfield and Brian G. King, "Private Rulings Regarding 'Cash Surrender Value' Under Section 7702," *TAXING TIMES*, vol. 2, no. 2 (September 2006) and John T. Adney and Alison Reynolds Peak, "Whither the Definition of 'Cash Surrender Value' – The IRS Issues More Waiver Rulings Discussing the Meaning of Section 7702(f)(2)(A)," *TAXING TIMES*, vol. 5, no. 2, (May 2009).
- <sup>3</sup> A key distinction in the definition of cash surrender value is the use of the "or" term. While the legislative history of section 7702 provides a definition of cash value that is based on the amount available "upon surrender and, generally, against which the policyholder can borrow," Treas. Reg. sec. 1.7702-2 substitutes an "or" for the "and" in its definition of cash surrender value. (See S. Print No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984).
- <sup>4</sup> See note 1, *supra*.
- <sup>5</sup> See STAFF OF THE J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 653-54 (J. Comm. Print 1984) ("DEFRA Bluebook").