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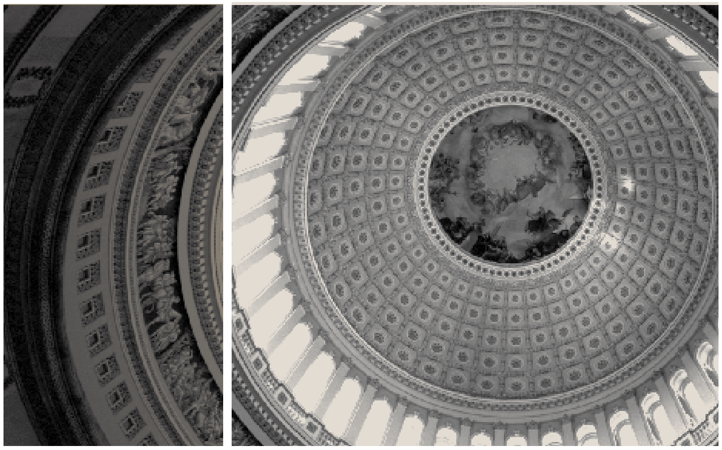

A MYSTERY PARTIALLY UNVEILED: THE IRS RULES ON SECTION 7702A'S NECESSARY PREMIUM TEST

By John T. Adney, Craig R. Springfield and Adam C. Harden

In private letter ruling ("PLR") 201137008, dated June 14, 2011 and released to the public on Sept. 16, 2011, the Internal Revenue Service (the "Service") issued its seminal ruling interpreting Internal Revenue Code section 7702A(c)(3)(B)(i),[1] commonly referred to as the "necessary premium test" or "NPT." The Service responded to a life insurance company's request that it be allowed to take certain expense charges into account in determining the "deemed cash surrender value" of a universal life insurance policy for purposes of the NPT, compliance with which might ultimately affect whether a policy is a "modified endowment contract" ("MEC") under section 7702A. In this PLR, the Service concluded that "reasonable expense charges" are properly taken into account in determining the deemed cash surrender value, which must be calculated in order to apply the NPT to a life insurance contract intended to satisfy the cash value accumulation test ("CVAT") of section 7702(a)(1) and (b). In reaching this decision, the Service reviewed various parts of section 7702A and relied heavily on the legislative history of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"),[2] which enacted the provision.

STATUTORY BACKGROUND AND FACTS OF THE RULING

Under section 7702A, increases in a policy's death benefits and in qualified additional benefits such as term life insurance riders covering family members ("QABs") are considered "material changes" subject to the rule in section 7702A(c)(3), which requires a reapplication (under special rules) of the premium limit established by section 7702A's "7-pay test." This reapplication of the 7-pay test can result in the policy's treatment as a MEC, thus subjecting distributions (including loans) from the policy during the insured's lifetime to a less favorable income tax regime than applies to a policy that is not a MEC (a "non-MEC").

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The purpose of the NPT is to shelter certain death benefit increases from material change status, avoiding the 7-pay test's reapplication on their account. The kinds of death benefit increases intended to be sheltered by the NPT include paid-up additions purchased by policyholder dividends under participating whole life insurance policies and, in the case of interest-sensitive whole life and universal life policies, death benefit increases resulting from the application of one of section 7702's minimum risk corridors when excess interest or earnings are credited or less-than-guaranteed charges are assessed.[3] The NPT also shelters death benefit increases under certain increasing death benefit patterns, such as under a so-called "option 2" death benefit where the death benefit equals the sum of a fixed amount of pure insurance and the policy's cash value. The condition imposed by the NPT for obtaining such shelter is that premiums must not have been paid for the policy higher than the cumulative amount needed to fund the lowest death benefit and QABs under the policy, *i.e.*, the "necessary premiums." For a CVAT policy, the legislative history of TAMRA, as further described below, generally defines a premium to be "necessary" if its amount is within the excess of the section 7702 net single premium for the policy (calculated assuming only the lowest benefits during the 7-pay period) over what it labeled the "deemed cash surrender value" of the policy.[4]

PLR 201137008 dealt with a universal life policy which it said would comply with the CVAT by providing a minimum death benefit equal to the product of the policy's cash surrender value (within the meaning of section 7702(f)(2)(A)) and a corridor factor that varied with the age and certain other characteristics of the insured. The policy, typical of universal life, provided for flexible premium payments, planned periodic premiums that may be paid, and an adjustable death benefit.

The PLR's statement of facts posited that the policy could be sold as either a MEC or a non-MEC. In circumstances where a policyholder desired the policy not to be or become a MEC, the insurer would identify, and the policyholder would pay, premiums intended to comply with the 7-pay test of section 7702A, thereby avoiding MEC status. Presumably because the policy's death benefit could increase due to its minimum death benefit provision and thus potentially could undergo material changes subject to the rule in section 7702A(c)(3), the insurer would need to apply the NPT to determine if a post-issuance material change arose under the policy. In turn, to apply the NPT, the insurer would need to know how to compute the policy's deemed cash surrender value for purposes of satisfying the NPT, raising the particular question presented to the Service in the insurer's PLR request. This question was: Can the expense charges related to the policy be deducted in computing that deemed cash surrender value?

The PLR indicated that the company represented to the Service that the expenses the insurer proposed to reflect in computing the deemed cash surrender value would satisfy the so-called reasonable expense charge rule of section 7702(c)(3)(B)(ii).

THE RULING AND ITS RATIONALE

In PLR 201137008, the Service issued the following ruling to the insurance company:

> For purposes of the necessary premium test under section 7702A(c)(3)(B)(i), reasonable expense charges are taken into account when determining the deemed cash surrender value of a policy intended to satisfy the Cash Value Accumulation Test under section 7702(b).

To reach this conclusion, the Service began its analysis by looking to subsections (a)(1), (b), (c)(3)(A), and (c)(3)(B) of section 7702A, which dictate the MEC status (or not) of section-7702-compliant life insurance policies entered into on or after June 21, 1988. As highlighted in the PLR's analysis, the statutory provisions yielded but little insight into the elements or operation of the NPT, and they mentioned the deemed cash surrender value not at all. Insight was provided, however, in the legislative history accompanying the enactment of section 7702A, and so the PLR's analysis relied heavily on this legislative history. (While the PLR did not say so, there are no regulations describing the NPT, a circumstance not unusual where sections 7702 and 7702A are concerned.)

The Service's analysis in the PLR next observed that the Conference Committee report on TAMRA, like section 7702A(c)(3)(B)(i) itself, implied that the purpose of the NPT is to allow for the payment of premiums "necessary to fund" a policy's future benefits—as defined in section 7702, these consist of the policy's death benefit, its endowment benefit, and the costs of any QABs—if those premiums must be paid to keep the policy in force.[5] The discussion in the PLR subsequently returned to this point, noting that a footnote in the Conference report instructs that if a policy's deemed cash surrender value exceeds its actual cash surrender value, the latter should be substituted for the former in the necessary premium calculation.[6] These observations helpfully framed the objective of the PLR exercise: to craft an answer to the insurer's question that would enable premiums to be paid to fund the policy adequately without creating a MEC.

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To define the operation of the deemed cash surrender value in particular, the Service then looked to the report of the House Ways and Means Committee on TAMRA.[7] That report described the deemed cash surrender value as:

> the cash surrender value (determined without regard to any surrender charge or policy loan) that would result if the premiums paid under the contract had been credited with interest at the policy rate and had been reduced by the applicable mortality and expense charges. For this purpose, in the case of a contract that satisfies the [CVAT], the policy rate equals the greater of 4 percent or the rate or rates guaranteed on the issuance of the contract.... The applicable mortality and expense charges for any contract are those charges that were taken into account for prior periods under the [CVAT]….[8]

The Service construed these statements to mean that a policy's deemed cash surrender value is calculated, to use the words of the PLR, "by accumulating premiums actually paid for the contract, net of expense charges specifically imposed against those premiums, at the minimum interest rate or rates assumed to be credited (the contractually guaranteed rate(s) or, if greater, the statutory minimum rate of 4 percent) less the mortality and expense charges that would be assessed against the cash surrender value." According to the PLR, the statements in the Ways and Means Committee's report demonstrated that the deemed cash surrender value for a policy is properly computed

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by taking into account the expense charges imposed under the policy, specifically in that the statements speak to the calculation of a cash surrender that, as of any point in time, is assured to be available to fund the policy's future benefits. The Service further reasoned, adverting to the Conference report's footnote mentioned above, that it would not be logical to allow a policy's actual cash surrender value, which obviously would be reduced by the policy's expense charges, to be used as a substitute for the deemed cash surrender value if the expense charges were not allowed to be taken into account for the latter. Congress, in other words, should not be assumed to have intended such an asymmetry.

Thus, the Service stated in the PLR that "if expense charges are taken into account in determining the cash surrender value of a CVAT contract, it is appropriate to reflect them in the deemed cash surrender value calculation." Also, in the case of the policy involved in PLR 201137008, the expense charges were said to be assessed against the premiums that entered into the determination of the policy's cash value. The Service thus held that it is appropriate to reflect the expense charges (which were represented to be reasonable) in the deemed cash surrender value of the policy for purposes of the NPT.

CONCLUSION

By issuing PLR 201137008, the Service made its initial foray into the land of the NPT—territory now being charted more broadly by the Necessary Premium Task Force of the Society of Actuaries' Taxation Section. In the PLR, the Service clarified that in applying the NPT to a CVAT policy, the deemed cash surrender value of the policy should be computed by taking into account the expense charges that are imposed under the policy—at least to the extent that the charges are "reasonable" within the meaning of section 7702(c)(3)(B)(ii). In so holding, the Service produced a ruling that reached a conclusion both logical and consistent with the stated goal of the authors of the TAMRA rules.

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

Craig R. Springfield is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at crspringfield@davis-harman.com.

Adam C. Harden is an associate in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at acharden@davis-harman.com.

END NOTES

1 Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

2 Pub. L. No. 100-647 (1988).

3 In addition to the provisions in the TAMRA legislative history discussed below, the Senate Finance Committee, in describing the material change rules and the NPT, noted that policyholder dividends would be considered "other earnings" that may increase the death benefit without triggering a material change. 134 Cong. Rec. S 12352, at 12353 (daily ed. Sept. 12, 1988).

4 Specifically, the TAMRA legislative history describes a "necessary premium" with respect to a policy that satisfies the CVAT in the following words:

> A premium is necessary to fund the lowest death benefit payable during the first 7 contract years to the extent that the net amount of the premium (i.e., the amount of the premium reduced by any expense charge) does not exceed the excess, if any, of (1) the attained age net single premium for the contract immediately before the premium payment, over (2) the deemed cash surrender value of the contract immediately before the premium payment.

H.R. Rep. No. 100-1104 (Conf. Rep.), at 104-105 (footnotes omitted) (the "TAMRA Conference Report").

5 *See id.*

6 TAMRA Conference Report, at 105, n. 3. The deemed cash surrender value and its actual counterpart will not always be equal; otherwise, a reference to a "deemed cash surrender value" would be unnecessary. The actual may exceed the deemed because, *e.g.*, the deemed cash surrender value is determined using only the rate or rates guaranteed on issuance or 4 percent, if greater, whereas the actual cash surrender value may be credited with "excess" interest or earnings. On the other hand, in the case of a variable contract, the underlying separate account investments may lose value, causing the actual to be less than the deemed cash surrender value.

7 H.R. Rep. No. 100-795, at 481 (1988).

8 *Id.*