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THEY GO BUMP IN THE NIGHT: LIFE INSURANCE POLICIES AND THE LAW OF MATERIAL CHANGE*

By John T. Adney and Craig R. Springfield

From ghoulies and ghosties
And long-leggedy beasties
And things that go bump in the night,
Good Lord, deliver us!

—Traditional Scottish prayer

Insurers' efforts to assure the compliance of their life insurance policies with federal tax requirements—principally sections 101(f), 7702 and 7702A[1]—rightly focus on the actuarial-driven tests imposed by these provisions of the Code. One of the many complexities entailed in these efforts, however, lies in the different tax rules that apply to different life insurance policies, in part because Congress has seen fit to revise (and further restrict) the federal tax treatment of life insurance from time to time, and also because of changes in state law that are relevant under the tax law, such as changes in the prevailing Commissioners' Standard Ordinary ("CSO") mortality tables. While the effective dates for new tax rules typically are based on when a policy is "issued" or "entered into," one of the

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things that can go *bump in the night* is a so-called "material change," which can cause a policy to be treated as newly issued or entered into so that it becomes subject to new tax rules, or perhaps to the same rules reapplied. In this article, we explore the labyrinthine interplay between the various effective date and other material change rules (under the statutes noted above and also under sections 1001, 264(f), 101(j) and 848[2]), the changes often made under policies, guidance from the Internal Revenue Service ("IRS") on the subject, and the reality that a change may be "material" in one context but not in another—truly *ghoulies and ghosties and long-leggedy beasties* that present challenges to tax compliance, to say the least.[3]

In addressing material change questions, a tension often exists between a desire to allow changes that commonly are permitted under life insurance policies in the absence of any tax issue relating to material changes (*i.e.*, conducting "business as usual") and a desire to ensure that a change does not inadvertently cause noncompliance or other adverse tax consequences. This tension often is exacerbated by the fact that many life insurance policies are sold with the intention of being dynamic rather than static instruments, and also by the fact that some changes reflect long-standing industry practices, such as permitting a change in smoking status or a rating (based upon a showing of cessation of smoking or a dangerous activity or of improved health), even if there is not an expressly stated right in the written terms of policies regarding the change. Also, even if a change is uncommon and not contemplated by the terms of a policy or industry practice, there may be little or no possible tax motivation or effect on a policy's investment orientation associated with making the change. A further complicating factor is that some changes are initiated by the insurer while others are initiated by the policy owner.

In this article, we first outline the different broad purposes served by the material change concept under federal tax law. We then turn to the more specific material change and similar issues that are pertinent to particular Code provisions and guidance from the IRS that has addressed those issues. In the final part of this article, we comment on whether any overarching principles can be gleaned that can assist insurers and policy owners in making decisions about whether particular changes can safely be made, and we offer thoughts with respect to future potential IRS guidance that would be helpful as taxpayers navigate these often uncertain waters.

TAX PURPOSES SERVED BY THE MATERIAL CHANGE RULES

When considering the effect of a proposed change to a life insurance policy under the tax law, it is necessary to examine each relevant statutory provision to ascertain the effect, if any, that the change will entail. In doing so, it is important to keep in mind that the material change concept serves a number of broad but distinct purposes under the tax law, depending upon the tax rules involved. These include the following:

- ***Determining when one property should be considered to have been replaced with another property (generally relevant for all tax purposes and especially for income recognition).*** As a general proposition, if one property is exchanged for another, section 1001(c) requires the owner to recognize any gain realized with respect to the property given in the exchange. For this purpose, in *Cottage Savings Association* v. *Commissioner*, the Supreme Court concluded that properties were "different" in a sense that was "material" where exchanged properties entailed legal entitlements that were different in kind or extent.[4] Thus, even though a property interest (in the case of *Cottage Savings*, portfolios of participation interests in mortgages) may seem to continue from an economic perspective or in legal form—*e.g.*, where a life insurance policy continues on the same form with the same policy number—a material change in the legal entitlements associated with the property interest can cause the changed property to be viewed as a different property than the original property, with the consequence that the first property is considered to have been exchanged for the second property for tax purposes. (Such a material change is sometimes called a "deemed exchange.") On the other hand, the mere exercise of an existing legal entitlement, such as an option set forth in a policy, arguably should not result in a deemed exchange since the terms of the original property are merely being carried out. In some instances, though, a change may be so fundamental that deemed exchange treatment cannot be avoided.[5]

The need to recognize income under section 1001(c) upon a deemed exchange of property is subject, of course, to various non-recognition provisions of the Code. In the case of an exchange of one life insurance policy for another, for example, income recognition usually is not required due to the tax-free exchange rule of section 1035. However, because an entirely new property is considered to arise factually upon a deemed exchange, *Cottage Savings* and related authorities are relevant to the analysis of material changes, especially in other contexts.[6]

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• ***Grandfathering.*** When there is a change in the law that applies prospectively, such as to policies "issued" or "entered into" on or after a particular date, older policies usually are not subjected to the new rules, *i.e.*, they are "grandfathered" and are subject to the rules in effect before the change. A general legislative policy that can be inferred from such effective date provisions is that Congress typically chooses not to upset existing contractual relationships by imposing rules or restrictions that could not have been contemplated by the parties to a contract when it was issued or entered into.[7] A balancing consideration, however, is that taxpayers should not be able to make material changes to their contracts after the effective date of a new tax rule in order to avoid application of the new rule to what are, in substance, new contracts.

Upon some material changes in the terms or benefits of a life insurance policy, it is necessary to reapply a statutory rule to the policy.

• ***Adjustments in applying statutory tests.*** In prescribing actuarial tests under sections 101(f), 7702 and 7702A, Congress recognized that the terms and benefits of a life insurance policy often may change after the policy's issuance and that any such change generally would need to be taken into account in applying the tests. Congress could have established rules, in a manner akin to *Cottage Savings*, treating policies as entirely new upon such changes. As discussed below, however, Congress generally chose not to follow this approach and instead provided specific and more narrowly tailored "adjustment" rules for addressing most post-issuance changes, *e.g.*, the adjustment rules of sections 101(f)(2)(E) and 7702(f)(7)(A), the reduction in benefits rule of section 7702A(c)(2) and (6), and in some respects the material change rule of section 7702A(c)(3).[8]

• ***Reapplication of statutory tests.*** Upon some material changes in the terms or benefits of a life insurance policy, it is necessary to reapply a statutory rule to the policy. For example, section 7702A(c)(3) provides that a materially changed policy is treated as newly entered into for purposes of section 7702A, and in consequence the 7-pay test must be reapplied to the materially changed policy. Such treatment is largely tantamount to a deemed exchange of one property for another property, although special rules govern which changes trigger a material change and how the material change is handled in reapplying the 7-pay test.

Another example of test reapplication appears in the context of section 264(f), which disallows a deduction for a portion of a taxpayer's otherwise deductible interest expense deemed allocable to unborrowed life insurance, annuity or endowment contract cash values. This disallowance rule is subject to an exception for certain policies covering insureds who were 20 percent owners, officers, directors or employees of the policy owner at the time first covered under the policy. If a material change causes a policy to be newly issued (so that insureds are considered to be covered under a new, different policy), the exception would no longer apply if the insured no longer is a 20 percent owner, officer, director or employee of the policy owner.[9]

Yet another example is in the context of section 101(j), which limits the application of the section 101(a)(1) exclusion from income for death benefits in the case of certain employer-owned life insurance policies. This limitation is subject to a number of exceptions, one of which is that the limitation does not apply if certain notice and consent requirements are satisfied and the insured was a director or a highly compensated employee or individual (as defined in section 101(j)(2)(A)(ii)) of the policy owner at the time the policy was issued. Similar to the concern under section 264(f), if a material change causes a policy to be treated as newly issued, the exception to the section 101(j) limitation may no longer apply if the insured is not a director or highly compensated employee or individual at the time of the material change.[10]

Part of the complexity associated with material changes is in ascertaining the effect of a change in light of the above ways in which they may be relevant to the tax treatment of a policy. While more than one of the above roles for material changes may apply in considering the effect of a change, some may be mutually exclusive or inapplicable, and thus it often is necessary to ascertain which particular material change rules are relevant to a particular transaction.

POLICY CHANGES UNDER SECTIONS 7702 AND 7702A—INTRODUCTION

Changes to a life insurance policy can raise a number of questions in the context of sections 7702 and 7702A, which respectively define the terms "life insurance contract" and "modified endowment contract" (or "MEC") for all purposes of the Code. First, section 7702, which was added to the Code by the Deficit Reduction Act of 1984 ("DEFRA"),[11] generally applies to policies "issued" after Dec. 31, 1984 (the "Section 7702 Effective Date Rule"),[12] and thus when a change is made to an earlier issued policy, it is necessary to determine whether the change causes the policy to be treated as newly issued and thereby subject to section 7702. Second, for a policy already subject to section 7702, the statute includes an adjustment mechanism (set forth in section 7702(f)(7)(A)) that addresses how a post-issuance change in the terms or benefits of a policy should be reflected in the actuarial calculations of guideline premiums and net single premiums under the statute. Third, section 7702's rules with respect to mortality and expense charges were amended by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA")[13] for contracts "entered into" on and after Oct. 21, 1988,[14] rendering it necessary to determine whether a change will subject a policy to these new rules (or to a reapplication of such rules).[15] Fourth, TAMRA added section 7702A to the Code, defining a MEC, and this provision generally applies to policies "entered into" on or after June 21, 1988.[16] This requires assessing whether a change to an existing policy will cause it to be treated as newly "entered into" on or after this date so that the policy becomes subject to section 7702A.[17] Fifth, a change to a policy already subject to section 7702A may be subject to one or the other of two adjustment rules contained in the statute: the rules for reductions in benefits under section 7702A(c)(2) and (6), and the material change rule of section 7702A(c)(3).

In the discussion below, we will focus on when changes should and should not be considered material in the context of these rules.[18]

DEFRA—THE SECTION 7702 EFFECTIVE DATE RULE

Issue Date of a Policy

As noted above, the Section 7702 Effective Date Rule provides that section 7702 applies to policies "issued" after Dec. 31, 1984, in taxable years ending after such date.[19] A number of questions relate to this rule. For example, what is the "issue date" of a policy? What changes to a policy can cause it to be treated as newly issued for tax purposes (or under state law)? Also, does it matter whether the policy is already subject to section 7702 or section 101(f) at the time the change is made? With respect to the first of these questions, the starting point for analysis is the language of the statute itself,[20] and thus the question presented is what a policy's "issue date" means as used in the Section 7702 Effective Date Rule. Further, an accepted principle of statutory construction is that, where a statute addresses a particular subject matter, such as life insurance policies, technical terms and phrases that pertain to that subject matter should be given their technical meaning when used in the statute.[21]

Life insurance policies typically state as part of a policy's terms (usually in the specifications pages) one or more dates that have relevance to the operation of a policy. The insurance law treatise *Couch on Insurance*, in discussing the beginning of a policy's contestable period, states that the term "date of issue" "refers to the date of issue appearing on the face of the policy, and not to the time of actual execution or delivery."[22] Thus, a policy's "issue date" generally is the issue date assigned by the insurance company, and in this respect it is somewhat within the discretion of the insurance company. This date generally serves to measure contestability and suicide periods under a policy.[23] Policy anniversaries and the dates for the assessment of contract charges also may be measured from this date.

The "issue date" will not, however, necessarily be the same as the date that a binding contract is entered into or the date coverage becomes effective. The term "issue date," while having fairly uniform usage in the life insurance industry, is subject to some variation in use because policies typically include their own definitions of the term, and the import of the term is dictated by the particular provisions of a policy. Also, policies may use one term (*e.g.*, issue date) for one purpose but another term (*e.g.*, effective date) for another purpose. This is not surprising, since the process of issuing a life insurance policy involves a number of steps, including the application for cover-

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age, examination of the insured's health and the underwriting process, provision of temporary coverage that may apply while underwriting is pending,[24] and the insurer's approval of coverage and issuance of the policy, with coverage becoming effective as of a date specified in the policy. Because of these steps, policies may provide for an issue date that differs from the date coverage becomes effective.[25] In addition, policies commonly provide that they will become effective only once they are delivered and the first premium due is paid, provided the insured is in good health on that date.[26] In commenting on this point, Buist Anderson observed that:

> [W]here an advance premium is not paid the life insurance policy usually is not effective until after the date the policy bears because of the common policy provision that the insurance shall not become effective unless and until the policy is delivered and the first premium paid during the applicant's lifetime and good health. The insurer does not know exactly when the policy will be delivered, and the practice is to date the policy as of the date it is executed at the home office of the company or a few days thereafter to allow for delivery.[27]

… the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed ….

In practice, there is frequently a time lag between the issue date and the entered into or effective date, and sometimes the lag is significant.[28]

Reflecting the industry usage of the term "issue date," the staff of the Joint Committee on Taxation's "Bluebook" explanation of DEFRA states that "[f]or purposes of applying the [Section 7702 Effective Date Rule] …the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed…."[29] Also, a footnote to this sentence in the DEFRA Bluebook states that "[t]he use of the date on the policy would not be considered the date of issue if the period between the date of application and the date on which the policy is actually placed in force is substantially longer than under the company's usual business practices."[30] Thus, the DEFRA Bluebook generally defers to the date assigned by the insurer as the "issue date," as long as the company has not altered its normal business practices with the purpose of avoiding the Section 7702 Effective Date Rule.

This legislative history does not, however, answer all questions with respect to the "issue date" of a policy, such as the proper date to use where a policy identifies more than one date or uses a term other than "issue date" (such as "policy date") in the manner normally served by "issue date." Thus, for example, if a policy states an "issue date" in a typical manner and it further identifies an "effective date" of coverage (which often would be after the "issue date" but might be before such date, such as where temporary coverage is provided), should the insurer be able to use either date for purposes of applying the Section 7702 Effective Date Rule? Use of the stated "issue date" seems contemplated by the statutory rule; also, since calculations under section 7702 are based on the coverage provided, use of the policy's "effective date" for purposes of applying the Section 7702 Effective Date Rule seemingly should be reasonable, too. Similarly, for purposes of identifying the date as of which calculations under section 7702 are made, it also seems reasonable to allow use of either date, although again, there is no guidance on this point.[31]

Material Changes May Cause a Deemed New Issuance

While the "issue date" identified in a policy generally will be used for purposes of the Section 7702 Effective Date Rule, the DEFRA legislative history indicates that a material change to a policy may cause it to be treated as newly issued so that it becomes subject to section 7702. In particular, in describing the Section 7702 Effective Date Rule, the Senate Finance Committee stated that:

> Contracts issued in exchange for existing contracts after Dec. 31, 1984 are to be considered new contracts issued after that date. For these purposes a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange.[32]

DEFRA Option Rule

The DEFRA Bluebook elaborated on this discussion, stating *inter alia* that "[t]he exercise of an option or right granted under the contract as originally issued does not result in an

exchange and thus does not constitute the issuance of a new contract for purposes of new section 7702 and any applicable transition rules if the option guaranteed terms that might not otherwise have been available when the option is exercised…" (the "DEFRA Option Rule").[33] While the DEFRA Bluebook does not represent official legislative history,[34] it can be said to mirror the tax law's material change principle as it later was articulated in *Cottage Savings* and serves to flesh out the more abbreviated material change discussion of the official report. For pre-DEFRA life insurance policies (*i.e.*, generally those issued prior to Jan. 1, 1985), the DEFRA Option Rule often will control which changes can be made to the policy without subjecting the policy to the requirements of section 7702. In particular, if the change is made to a pre-DEFRA policy pursuant to an option granted under the policy, the exercise of that option usually will not cause the policy to be viewed as newly issued for purposes of the Section 7702 Effective Date Rule.

This still leaves the problem, however, that it is not always clear whether certain changes fall within the ambit of the DEFRA Option Rule. For example, a policy may include an express right to increase its death benefit, but this right is subject to underwriting approval by the insurer. Does this limitation on the policy owner's right take it out of the option rule? The answer would appear to be "no," as in this circumstance the insurance company would need to employ reasonable underwriting guidelines, and thus its discretion to deny a requested increase is limited by an ascertainable standard. The owner clearly possesses an enforceable contractual right, albeit one that is subject to a contingency (being in good enough health to pass underwriting). As discussed later, the IRS has followed this view in connection with the application of the reasonable mortality and expense charge rules of section 7702(c)(3)(B)(i) and (ii).[35]

As another example, issuers commonly permit changes in smoking status or a rating if the insured satisfies the underwriting criteria for the improved status, even though there may not be an express right to make the change under the terms of the policy. By what standard must the DEFRA Option Rule be applied in these circumstances? Seemingly, an owner would need to possess a contractually enforceable right to make the change in order fairly to characterize it as an "option"; similarly, under the analysis of *Cottage Savings*, which focuses on whether there has been a change in legal entitlements, one would want to be able to say that the terms (legal entitlements) of the existing policy have been implemented rather than bilaterally changed. In the absence of an express contractual provision regarding the change contemplated, however, it is necessary to examine whether an enforceable right otherwise exists in order to determine whether the change falls within the option rule.

Although such an examination will depend on the law of the state that governs the interpretation of the policy and on all of the relevant facts, several general observations are in order. First, with limited exceptions, the law relating to the interpretation of contracts generally will prevent the use of evidence beyond the four corners of a policy to contradict or supplement the written terms of the policy.[36] However, in some instances extrinsic evidence, such as usage of trade and course of performance or dealing, can be used to interpret and supplement the written terms of a policy.[37] Also, state laws generally prohibit discrimination among policy owners of the same class.[38] Given this, and the long-standing industry practice of allowing changes in smoking status and ratings under life insurance policies in defined circumstances, one may reasonably ask whether insurers can generally allow such changes where there is no material change concern yet deny a request for the same change if a material change issue is implicated. It could be argued that the two circumstances are not comparable, in that one of the policies was issued before the Section 7702 Effective Date Rule while the other was issued after such date. This is circular, however, since there is only a difference in tax status by reason of the material change issue, which of course would be resolved favorably if an enforceable right is possessed by the policy owner, *e.g.*, based on usage of trade, to make the change.

Changes in Minor Administrative Provisions

A further question regards the scope of the phrase "minor administrative provisions" as used in the Senate Finance Committee's description of the Section 7702 Effective Date Rule. Under this legislative history, even if a change is not made pursuant to an option, it usually will not cause the policy to be viewed as newly issued if the change can be characterized as merely a change in a minor administrative provision or in the interest rate on a policy loan. The scope of a "minor administrative provision," however, is nowhere spelled out apart from the above-quoted language according it the same treatment as a change in a policy loan rate. The Senate Finance Committee description merely contrasts changes

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in such minor administrative provisions with changes to the terms of a policy which generally would result in a material change, *i.e.*, a change in the amount or pattern of death benefit, the premium pattern, the interest rate(s) guaranteed on issuance of the policy, or mortality and expense charges. Thus, if the change does not relate to one of these elements, or otherwise to an element that is relevant to the determinations of guideline premiums or net single premiums under section 7702, arguably it is a minor one that should not cause a pre-DEFRA policy to become subject to section 7702. As a further consideration, a fundamental purpose underlying effective date rules is not to upset existing contractual arrangements with legislative changes that were unknown to the parties to the contract when it was formed. Thus, when evaluating whether a contemplated bilateral change to a policy constitutes a change in a "minor administrative provision," it may be instructive to ask whether the change is so substantial that it is reasonable at that time to subject the parties to the new tax regime.

Changes to Policies Already Subject to Section 7702 or 101(f)

So far, we've been discussing the circumstances in which a pre-DEFRA policy may be viewed as newly issued due to a material change so that it becomes subject to section 7702. But what about a material change in the terms or benefits of a policy, not pursuant to an option, that is already subject to section 7702 or to its statutory precursor, section 101(f)? On the one hand, the DEFRA Bluebook discussion of the Section 7702 Effective Date Rule seemingly would view the policy as newly issued, and section 7702 would apply anew to a policy already subject to it, or for the first time to a policy previously governed by section 101(f). On the other hand, the adjustment rules of sections 7702(f)(7)(A) and 101(f)(2)(E), respectively, arguably control the treatment of the change, since the change does not alter the policy's "issue date" under state law (or otherwise represent a fundamental change to the policy, as discussed below) and these Code provisions are specific statutory rules that were intended by Congress to account for changes under a policy.[39]

In this regard, a tenet of statutory construction is that more specific statutory rules govern over more general rules.[40] This tenet arguably provides a basis for concluding that the adjustment rules, rather than the legislative history pertaining to the Section 7702 Effective Date Rule, apply to address the treatment of a policy change that they are capable of handling. Congress obviously intended for these rules to account for changes in the terms or benefits of policies, and it seems farfetched to surmise that Congress intended that only non-bilateral changes would fall within the ambit of the rules. If such a result were intended, seemingly Congress would have provided some more direct indication to this effect in the statute or legislative history, especially since section 7702(f)(7)(A) was part of the same legislation (*i.e.*, DEFRA) that enacted the Section 7702 Effective Date Rule, and since section 101(f)(2)(E) had only recently been enacted and formed the basis on which section 7702(f)(7)(A) was modeled.[41] Also, in the case of a policy already subject to section 7702, the statute treats it as a "life insurance contract" for federal tax purposes if it constitutes a life insurance policy under "applicable law" and meets the statute's mathematical tests. If a change causes section 7702 to reapply to the policy, the same policy that constituted life insurance under applicable law would relate to two "life insurance contracts" for purposes of section 7702, a result that doesn't appear to be contemplated under the statutory regime.[42]

There are other good reasons for not construing the scope of the Section 7702 Effective Date Rule in an overly broad manner. In the case of a death benefit increase not made pursuant to an option, for example, the adjustment rules generally would increase guideline premiums by the attained-age guideline premiums applicable to the amount of increase.[43] In contrast, if the policy were viewed as newly issued, guideline premiums would be calculated entirely anew, *e.g.*, the guideline single premium would reflect the insured's attained age at the time of the change for all benefits, not just the increase.[44]

In 2007, the IRS issued a Chief Counsel Advice ("CCA") memorandum, CCA 200805022, dealing with the change in a life insurance policy's death benefit option and the addition of a qualified additional benefit ("QAB") to the policy.[45] In this CCA, the taxpayer (an insurer) wanted to permit its policy owners to change from an "option 2" or increasing pattern of death benefit to an "option 1" or level death benefit pattern and to add certain QABs, even though the policies did not specifically permit such changes. The CCA noted that the taxpayer had a practice of permitting additions of QABs with evidence of insurability. Some of the policies were issued before Jan. 1, 1985, and were subject to the requirements of section 101(f).[46] The CCA concluded that section 7702 would apply to pre-DEFRA policies changed in the manner just described. In explaining its views, the IRS noted that the changes would not satisfy the DEFRA Option Rule, and thus

such changes would cause the policies to be newly issued for purposes of the Section 7702 Effective Date Rule. The CCA did not discuss the potential application of the adjustment rule of section 101(f)(2)(E) as the more specific, and thus controlling, statutory provision.

Unfortunately, the proper treatment of policy changes under section 7702 (and section 101(f)), especially those not pursuant to an option granted in the policy, is just not clear. In large part the uncertainty arises because of the ill-defined relationship between section 7702 and the general material change principle embodied in *Cottage Savings*. Are they independent of one another, so that the general principle governs, for example, whether there has been an exchange for tax purposes, while the specific statutory scheme exclusively governs whether a property is considered as a "life insurance contract"? Or does one dictate the result for the other? In particular, if there is an exchange based on *Cottage Savings*, would this *always* mean that there is a new life insurance policy, so that sections 7702 and 7702A would need to be applied anew to the policy? Alternatively, since section 7702 defines "life insurance contract" for all purposes of the Code, contains an adjustment mechanism that specifically addresses policy changes, and contemplates that such changes would not result in a wholly new application of the statute, does this mean that no exchange should be deemed to exist in a case where there is not a new life insurance policy for purposes of section 7702 (which applies for all tax purposes)? It is perhaps the age-old question of whether the tail is wagging the dog, but in this case it's unclear which is the tail and which is the dog.[47]

Fundamental Changes

The above discussion explains why the adjustment rules of sections 101(f) and 7702 may control the treatment of changes to policies in circumstances where the DEFRA Option Rule is inapplicable. Even if such treatment is appropriate, a further question is whether there are changes that are so significant that policies always should be treated as newly issued, so that the adjustment rules would not be used to account for the changes. The legislative histories of sections 101(f) and 7702 do not directly address this question. However, a few principles can be gleaned from the authorities. First, if under state law a policy is treated as new, it usually will be necessary to treat the policy as new for federal tax purposes.[48] Thus, if a policy has a new issue date, policy number, new contestability and suicide periods, and otherwise is accounted for under state law as a new policy, that characterization usually will apply for federal tax purposes. This also generally follows from the fact that section 7702 attaches, in the first instance, to policies that constitute life insurance under applicable law (generally state or foreign law).[49]

What about a circumstance in which there is not a new policy under "applicable law"? While state law identifies the existence of legal rights, federal tax law generally governs the import of those rights,[50] and thus there may be circumstances where a change is so significant that it is appropriate to treat the policy as a newly issued contract for purposes of section 7702. But whether and when this is the case represents perhaps one of the more elusive ghosties associated with material change questions, in part due to the paucity of guidance and also because the adjustment rule of section 7702 and similar rules under section 7702A are quite capable of accounting for significant changes. These particular ghosties lurk in out-of-the-way places as well, such as in a decades-old revenue ruling, a legislative history footnote and a few instances of informal guidance.

First, in Rev. Rul. 90-109, the owner possessed a contractual right to change the insured under a key person life insurance policy. In analyzing the tax treatment of a change of insured, the IRS noted that "[a] change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option." The IRS went on to observe that a change in insured in the context of an actual exchange would be subject to tax under section 1001 (*i.e.*, section 1035 would not apply due to the requirement that the insured remain the same under Treas. Reg. section 1.1035-1) and that the change of insured "resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract."

While Rev. Rul. 90-109 holds that the change of the life insured under the policy constitutes "a sale or other disposition under section 1001 of the Code," meaning that the gain in the policy is includible in the owner's income for tax purposes, the ruling does not explicitly address the effect of the change under section 7702. However, since the ruling concludes that the change is so significant that it is proper to view the existing property as terminated and as having been replaced

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by a different property, it is possible that the ruling's holding may apply more generally for tax purposes, including under section 7702. This is far from clear, however, in that the adjustment rule of section 7702 is capable of accounting for a change of insured, and perhaps it should. When an insurer and a policy owner enter into a policy covering a key person, the owner is provided with valuable guarantees, including a minimum interest rate and maximum expense and mortality charges that can be assessed under the policy. While a change of insured may represent an appropriate time to tax the gain under a policy pursuant to section 1001, this does not necessarily mean that the existing contractual relationship should be upset by treating the change as giving rise to a new policy for all tax purposes, given that there is a more specific statutory regime (the adjustment rules) that can account for the change. Of course, insurers and policy owners may or may not desire new issuance treatment, *e.g.*, for ease of administration.[51]

Also , a change of insured under a key person policy is a very different transaction from an actual exchange, where generally the entire policy is replaced with another, often one issued by a different insurer.

In a sense, a change of insured pits section 7702 against the regulations under section 1035. On the one hand, section 7702 defines a unitary asset—the "life insurance contract"—for all purposes under the Code and treats a policy as the same "life insurance contract" after adjustment events while, on the other hand, the section 1035 regulations deny tax-free treatment where there is a change of insured. One can perhaps question whether the "same insured" requirement of section 1035 should control the tax result in all contexts, especially since change-of-insured provisions under key person policies apply in a very limited circumstance, no cash is necessarily received by reason of such a change, the policy continues on the same form for state law purposes, and valuable guarantees under the policy persist as well. Also, a change of insured under a key person policy is a very different transaction from an actual exchange, where generally the entire policy is replaced with another, often one issued by a different insurer. It is worth noting that the notion of a "fundamental change" does not seem well developed in the pertinent authorities. Rev. Rul. 90-109 has rarely been cited, and *Cottage Savings* and its progeny do not appear to cast the disposition question in these terms. The preamble to the final regulations issued under section 1001, however, comments that "for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the 'fundamental change' concept articulated in Rev. Rul. 90-109 (1990-2 C.B. 191), in which the IRS concluded that the exercise by a life insurance policy owner of an option to change the insured under the policy changed 'the fundamental substance' of the contract, and thus was a disposition under section 1001."[52] Also, certain non-precedential authorities have invoked the fundamental change concept.[53]

A further example which conceivably could reflect the elusive "fundamental change" concept relates to the following footnote from the DEFRA Bluebook, regarding the election of a nonforfeiture option under a policy:

> A change from the guideline premium test to the cash value accumulation test may occur, however, in those limited circumstances under which a contract need not continue to meet the guideline premium test because by the election of a nonforfeiture option, which was guaranteed on issuance of the contract, the contract meets the cash value accumulation test by the terms of the contract. However, any reinstatement of the original terms of such a contract would also reinstate the application of the original guideline premium test to the contract.[54]

In this instance, given that nonforfeiture options structurally are more suitable to compliance with the cash value accumulation test of section 7702(b), and perhaps reflecting the practical consideration that no further premiums are paid once a nonforfeiture option has been elected, the DEFRA Bluebook contemplates that the policy may "test switch," even though a change from the guideline premium test to the cash value accumulation test normally is not permitted. The general impermissibility of test switching is a consequence of the requirement—under both the guideline premium test and the cash value accumulation test—that the applicable test must be met *at all times* during the life of the policy. In some sense, the above DEFRA Bluebook footnote contemplates that one policy was in existence prior to the election of the nonforfeiture option, another was in existence thereafter, and possibly the original policy might come back into existence (truly a case of otherworldly resurrection), at least for purposes of allowing use of one test versus the other.

The DEFRA Bluebook footnote's approach is eminently practical and appropriately reflects the changing nature of the underlying policy. However, in order to work as intended, it is important to bear in mind that, apart from the use of one test or the other for specified periods of time, the policy should still be considered the same policy as has always been in existence. The election of a nonforfeiture option should not, for example, affect the "issue date" of the policy. If it did, the mortality charges specified for the nonforfeiture option might be different than the then prevailing mortality table at the time the option is elected, which often could prevent the policy from satisfying the cash value accumulation test. The footnote raises other interesting questions as well, such as how the sum of guideline level premiums should be determined following a reinstatement after the nonforfeiture option was in effect.

TAMRA—REASONABLE CHARGE AND SECTION 7702A EFFECTIVE DATE RULES

In General

In 1988, the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") made certain changes to section 7702(c)(3)(B)(i) and (ii), imposing more restrictive rules with respect to the mortality and expense charges that can be assumed for purposes of the section 7702 computations (the "Reasonable Charge Rules"). The Reasonable Charge Rules apply to "contracts *entered into* on or after October 21, 1988"[55] (the "Reasonable Charge Effective Date Rule"). TAMRA also enacted the definition of a MEC, which generally applies to "contracts *entered into* on or after June 21, 1988"[56] (the "MEC Effective Date Rule").

Meaning of "Entered Into"

Unlike the Section 7702 Effective Date Rule, which is based on the date a policy is "issued," the Reasonable Charge Effective Date Rule is based on the date a policy is "entered into." The use of a different term raises an initial question about how they are different. Whereas "issue date" has a technical meaning under state insurance law and generally refers to the date identified in a policy as the "issue date," the term "entered into" does not appear to have a meaning that is specific to the insurance context. In the absence of any statutory indication that the words "entered into" should possess a special meaning, under normal principles of statutory interpretation the term should be construed in accordance with its ordinary, plain meaning.[57] In the case of a life insurance policy (or any other type of contract), the plain meaning of "entered into" should be considered the date when the parties to the contract first enter into a binding contractual agreement (*i.e.*, the policy) under state or other applicable law—in other words, the date when contract formation occurs.[58] This is consistent with a definition of "enter" in Black's Law Dictionary, which includes the following definition for the term: "To become a party to <they entered into an agreement>," [59] and with a definition of "enter into" in Webster's Third New International Dictionary, which defines the phrase in part as "to make oneself a party to or in."[60] It is also consistent with statements of the IRS in other contexts. For example, in Notice 89-15, 1989-1 C.B. 634, the IRS addressed, among other issues, the interpretation of the effective date of section 460, which addresses the accounting method for long-term contracts. Enacted in 1986, section 460 is effective for "contracts entered into after February 28, 1986." In discussing the application of this rule to contracts subject to future conditions, the IRS stated that, regardless of such future conditions, a taxpayer is considered to have "entered into" a contract once "the contract is a binding contract under applicable law." [61]

The legislative history of TAMRA indicates that Congress' decision to reference the date a policy is "entered into" rather than its "issue date" was a deliberate one, reflecting concerns that were quite different from those that applied at the time of DEFRA. In particular, the House Report for TAMRA, in commenting on the proposed effective date of section 7702A (which also was enacted by TAMRA and also is based on the date a policy is "entered into") states that a policy will be considered "entered into" no earlier than "the date that (1) the contract is endorsed by both the owner of the contract and the insurance company; or (2) an application is executed by both the applicant and the insurance company and a premium payment is made by the applicant to the insurance company."[62] The TAMRA House Report goes on to state that "[t]he backdating of an application or an insurance contract shall be disregarded for purposes of this effective date."[63] While this discussion was not repeated in connection with the Reasonable Charge Effective Date Rule, the use of "entered into" in both contexts achieves the same result, *i.e.*, it prevents use of a date that precedes contract formation. Thus, although Congress in DEFRA was sympathetic to helping companies make a smooth transition to new section 7702 and chose to use "issue date" in DEFRA for this purpose, the situation was different in 1988, and Congress therefore chose less nondiscretionary "entered into" date to prevent abuse.

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When Can a Change Cause an Existing Policy to Be Newly Entered Into?

In contrast to the Section 7702 Effective Date Rule, the legislative history that accompanied the enactment of the Reasonable Charge Effective Date Rule did not directly address the circumstances in which changes to an existing policy would cause the policy to become subject to the new rule. However, the provisions of TAMRA and its legislative history are instructive on this point in two respects.

First, the effective date of the Reasonable Charge Effective Date Rule, as originally proposed as part of the Miscellaneous Revenue Act of 1988 (the "1988 Bill")[64] that later became TAMRA, was phrased quite differently from the Rule as eventually enacted. As noted above, the Reasonable Charge Effective Date Rule merely states that the Reasonable Charge Rules apply to "contracts *entered into* on or after October 21, 1988." Section 346(c) of the 1988 Bill, however, generally provided that the amendments would apply to "contracts issued" on or after July 13, 1988, and it went on to include the following special rule: "The rules of section 7702A(c)(3) of the 1986 Code (as added by this Act) [relating to material changes] shall apply in determining whether a contract is issued on or after July 13, 1988."[65]

In the conference agreement for TAMRA, the effective date rule was modified to its final form (*e.g.*, "contracts issued" was changed to "contracts entered into"), and the language incorporating the section 7702A(c)(3) material change rule was deleted. The conference report for TAMRA provides no explanation for the change, simply stating that "[t]he conference agreement follows the House bill, with modifications… The provision is effective with respect to contracts entered into on or after October 21, 1988."[66] From this legislative history, it seems clear that Congress did not want to apply the material change rule of section 7702A(c)(3)—at least as a general matter—for the purpose of determining whether a change causes a policy to be newly "entered into."[67] This legislative history also shows that Congress considered whether to establish an express material change rule and decided not to do so.

Second, while Congress was silent regarding the circumstances in which changes might cause a policy to be newly "entered into" for purposes of the Reasonable Charge Effective Date Rule, it included detailed material change rules for purposes of the MEC Effective Date Rule. In particular, TAMRA section 5012(e) includes the following two rules for purposes of determining whether a change will cause a policy to become subject to section 7702A:

> (2) If the death benefit under the contract increases by more than $150,000 over the death benefit under the contract in effect on October 20, 1988, the rules of section 7702A(c)(3) … shall apply in determining whether such contract is issued on or after June 21, 1988. The preceding sentence shall not apply in the case of a contract which, as of June 21, 1988, required at least 7 level annual premium payments and under which the policyholder continues to make level annual premium payments over the life of the contract…."[68]
>
> (3) A contract entered into before June 21, 1988, shall be treated as entered into after such date if—(A) on or after June 21, 1988, the death benefit under the contract is increased (or a qualified additional benefit is increased or added) and before June 21, 1988, the owner of the contract did not have a unilateral right under the contract to obtain such increase or addition without providing additional evidence of insurability, or (B) the contract is converted after June 20, 1988, from a term life insurance contract to a life insurance contract providing coverage other than term life insurance coverage without regard to any right of the owner of the contract to such conversion.

In considering changes that are commonly made under life insurance policies, perhaps the most significant of the above rules is TAMRA section 5012(e)(3)(A), since under it any underwritten increase in the death benefit or a QAB will cause the policy to be newly "entered into" for purposes of the MEC Effective Date Rule. Thus, in the case of pre-TAMRA adjustable death benefit policies, insurers generally should have procedures in place to warn owners that such increases, if made, will cause their policies to become subject to section 7702A. Beyond these changes, however, the transition rules for the MEC Effective Date Rule expressly treat changes as resulting in a newly "entered into" contract only in limited circumstances, *i.e.*, term conversions and certain non-underwritten death benefit increases in excess of $150,000 which would give rise to material changes under section 7702A(c)(3). This latter rule is somewhat odd, in that it applies a portion of a statute in order to determine whether that same statute applies to a policy. However, it is a beneficial rule in that it prevents automatic death benefit increases after June 20, 1988 due merely to the use of policyholder dividends to purchase paid-up additions or to the crediting of premiums and earnings (such as those where a so-called "option 2" death benefit applies)

from causing a policy to become subject to section 7702A, as long as actual premiums are "necessary" within the meaning of section 7702A(c)(3)(B)(i).

The question still remains, however, regarding the scope of changes that may cause a policy to be newly "entered into" as a general matter. Stated differently, in the case of a life insurance policy "entered into" prior to Oct. 21, 1988 (in connection with the Reasonable Charge Rules) and prior to June 21, 1988 (in connection with the MEC rules), what changes beyond those specifically addressed in the MEC context will cause a policy to be newly "entered into" and thus subject to the new rules? While a bilateral change causes a policy to have different terms than applied before the change, and thus in a sense there is a new contract after the change, modifications to a policy (such as through addition of an amendment) are not normally thought of as changing the date of contract formation or of creating a new contract.[69] As noted above, to answer this question it is helpful to examine the TAMRA effective date rules and their legislative history, *e.g.*, that a material change rule was considered and ultimately rejected for the Reasonable Charge Effective Date Rule, as well as the special effective date rules of TAMRA section 5012(e)(2) and (3) which, while relating only to the MEC Effective Date Rule, are instructive for interpreting both sets of effective date rules. In particular, the legislative history and these special rules imply a much more limited scope for the changes that may cause a policy to be newly "entered into." It also may be relevant whether the pre-TAMRA policy already is subject to section 7702.

With respect to the special effective date rules of TAMRA section 5012(e)(2) and (3), it is noteworthy that these rules represent modifications of the normal meaning of "entered into," since otherwise they would not have been needed to supplement the general effective date rule of TAMRA section 5012(e)(1). Thus, for example, Congress' inclusion of TAMRA section 5012(e)(3) implies that an underwritten death benefit increase or term conversion would *not*, in and of themselves, cause a policy to become newly entered into. Why else would Congress go to the trouble of specifically providing special rules to this effect—*i.e.*, providing that such increases or conversions cause a policy to become subject to section 7702A—if such changes otherwise would cause a policy to be newly "entered into"?

Also, if changes other than those addressed by TAMRA section 5012(e)(2) and (3) generally should not cause a policy to be newly "entered into" for purposes of the MEC Effective Date Rule by reason of this implication, does this implication also apply in the context of the Reasonable Charge Effective Date Rule? As discussed above, there are no special effective date rules under section 5011(d) of TAMRA modifying "entered into" for purposes of the Reasonable Charge Effective Date Rule, nor does any discussion of either rule appear in the legislative history. Given (1) that these effective date rules are companion statutes (*i.e.*, they were both part of TAMRA and pertain to the tax rules applicable to life insurance), and (2) the fact that a material change rule was considered for the Reasonable Charge Effective Date Rule and rejected, there is no reason to believe the Congress would have intended a different meaning of "entered into" between these two effective date rules as a general matter. Further, since Congress chose not to impose the TAMRA section 5012(e)(2) and (3) rules for purposes of the Reasonable Charge Effective Date Rule, arguably such changes were not intended to cause a policy to be newly "entered into" for purposes of this Rule.[70]

This view of the application of the TAMRA effective date rules is not beyond dispute, however. As discussed above, the treatment of changes for purposes of the Section 7702 Effective Date Rule largely depends on whether a change is made pursuant to a right (an option) set forth in the policy as in effect prior to the effective date. Also, insofar as the DEFRA legislative history (including the DEFRA Option Rule) arguably reflects general tax principles regarding material changes, one might expect similar treatment of policy changes to apply for purposes of TAMRA's effective date rules. Further, since TAMRA's changes were directed, at least in part, at certain abusive arrangements,[71] one can reasonably ask whether Congress would have intended to apply an arguably more generous effective date rule in connection with TAMRA than it applied with respect to DEFRA's changes. Resolution of this seeming inconsistency may lie in the fact that Congress wanted to impose a less discretionary application date for the new tax rules ("entered into" rather than "issue" date) for the reasons discussed above. Also, for the MEC Effective Date Rule, Congress did impose a more

Also, for the MEC Effective Date Rule, Congress did impose a more restrictive regime, since it expressly treated many increases in benefits as triggering application of the new tax rules.

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restrictive regime, since it expressly treated many increases in benefits as triggering application of the new tax rules. By laying out express material change rules, Congress may have achieved more certainty than was offered by DEFRA's committee report commentary, but it arguably protected existing contractual arrangements from application of the Reasonable Charge Rules to some greater degree than would have been the case had a rule identical to the Section 7702 Effective Date Rule applied.

Congress' approach would appear to reflect a desire not to force older, 1958 CSO policies to change their guaranteed values to reflect the 1980 CSO tables whenever endorsements or riders are added. If such policies were forced to change to the 1980 CSO (or later) tables whenever an endorsement or rider was added, this would make the addition of endorsements and riders impractical and burdensome, since it often would require an issuer to recalculate the policy's guaranteed values, which frequently would not be feasible. In short, 1958 CSO policies in many respects would effectively be "frozen" in place, to the disadvantage of policy owners. Congress reasonably concluded, it would seem, that this is undesirable.[72]

This is unclear, however. As noted above, in CCA 200805022, the IRS addressed changes in a life insurance policy's death benefit option and the addition of QABs to the policy, even though the express terms of the policy did not contemplate such changes. While some of the policies were pre-DEFRA (as discussed above), others were issued on and after Jan. 1, 1985, but before Oct. 21, 1988. The CCA concluded that such changes to a policy would cause it to be newly "entered into" for purposes of the Reasonable Charge Effective Date Rule. In reaching this conclusion, the IRS noted the legislative history of TAMRA's changes, *i.e.*, the TAMRA House Report's indication that the Reasonable Charge Rules would apply to policies issued or materially changed after the effective date and that the Conference agreement followed the House bill (*i.e.*, the 1988 Bill) with modifications.[73] The IRS then stated that: "Therefore the 'material change' language that is referenced by the House version of the effective date provisions for the unreasonable mortality charge rules of § 7702 will cause a life insurance contract to be entered into anew (for purposes of §7702(c)(3)(B)) if there is an increase in future benefits." It is unclear why the IRS thought the legislative history supported this conclusion, since the Conference agreement with respect to the Reasonable Charge Effective Date Rule included modifications (a change from "issued" to "entered into" and the dropping of the statutory provision for material changes) which, as discussed above, lead to an opposite conclusion. There also was no discussion of the implications that can be drawn from the special effective date rules that apply as part of the MEC Effective Date Rule.

The above discussion—supporting a limited view of changes that can cause a policy to be newly "entered into"—makes the most sense in the context of a policy that is already subject to section 7702 (including the pre-TAMRA mortality charge rule), since the Section 7702 Effective Date Rule arguably is inapplicable to such a policy (and the section 7702 adjustment rule should address any changes).[74] However, if there is a change on or after Oct. 21, 1988, to a policy not subject to section 7702 which causes it to be treated as newly issued for purposes of the Section 7702 Effective Date Rule, section 7702 would attach to the policy at that time, including the mortality charge rule of section 7702(c)(3)(B)(i) as then in effect. Thus, for pre-DEFRA policies, a post-TAMRA change that causes the policy to be newly "issued" seemingly would cause it to become subject to the Reasonable Charge Rules regardless of the arguments above relating to whether the change would cause the policy to be newly "entered into." Further, if there were a fundamental change under any policy (and assuming that such a distinction might be made under the tax law), seemingly the changed policy would become subject to the Reasonable Charge Rules regardless of when the prior policy was issued or entered into.

REAPPLICATION OF SECTION 7702'S REASONABLE MORTALITY RULE

We've just discussed the circumstances in which changes to a pre-TAMRA policy may cause it to become subject to the Reasonable Charge Rules, encompassing both the reasonable mortality charge rule of section 7702(c)(3)(B)(i) (the "Reasonable Mortality Rule") and the reasonable expense charge rule of section 7702(c)(3)(B)(ii). A further "material change" question regards when a change to a policy already subject to the Reasonable Mortality Rule will result in a reapplication of that rule. This Rule states that calculations must be based on:

> Reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) 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[.][75]

Ascertaining whether a change causes a policy to be newly "issued" for purposes of this rule often is an important consideration for purposes of assuring compliance with section 7702. For many policies (such as ordinary whole life insurance), reapplying the Reasonable Mortality Rule could result in a failure to comply with section 7702 since the policies' values may be based on a prior prevailing mortality table. Also, even in the case of other policies (such as universal life), reapplying the rule may be problematic, *e.g.*, because the insurer may not realize that a change to the policy has triggered reapplication of the rule or because the section 7702 calculations on the insurer's computer-based administration system for all policies issued on a particular form may be based on the prior prevailing mortality table and it may not be feasible to test a subset of policies (those which have been materially changed) using a new mortality table.[76]

These considerations often cause insurers to restrict the changes that are permitted under policies for which section 7702 calculations are based on a prior prevailing mortality table, even if the insurer routinely would permit particular changes absent the risk that the Reasonable Mortality Rule might be reapplied. The IRS has issued helpful guidance in this regard—in particular Notice 2006-95 (the "Notice")[77] —which sets forth certain safe harbors permitting use of mortality charges based on particular prevailing mortality tables. These safe harbors generally permit the use of charges based on 1980 CSO mortality in the case of policies issued prior to Jan. 1, 2009. For policies issued on and after that date, however, a safe harbor is provided only with respect to the use of charges based on 2001 CSO mortality, in reflection of the fact that this table had earlier become the prevailing mortality table.[78] The Notice also specifically addressed when changes would be considered to result in a newly issued policy for purposes of applying these safe harbors. In particular, the Notice includes two rules, either of which if met will prevent a policy from being considered newly issued. The first of these rules is set forth in Notice section 5.01 and states that:

> The date on which a contract was issued generally is to be determined according to the standards that applied for purposes of the original effective date of [section] 7702. <u>See</u> H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1076 (1984), 1984-3 (Vol. 2) C.B. 330; <u>see also</u> 1 Staff of Senate Comm. On Finance, 98th Cong., 2d Sess., <u>Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984</u>, at 579 (Comm. Print 1984). Thus, contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange. For these purposes, a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (that is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, and mortality and expense charges) are the same as the terms of the contract prior to the change.[79]

By cross-referencing the Section 7702 Effective Date Rule, this rule in section 5.01 of the Notice should produce the same result (*i.e.*, give rise to a new issuance of a policy or not) as would apply under the Section 7702 Effective Date Rule. While the Notice did not cite to the DEFRA Bluebook's discussion of the Section 7702 Effective Date Rule, that omission likely simply reflected the Bluebook's status as semi-official legislative history. However, to the extent that that discussion follows general material change principles under the tax law (which appears to be the case), it would seem that the DEFRA Bluebook discussion, including the DEFRA Option Rule, is pertinent for purposes of applying Notice section 5.01.

The second rule regarding material changes is set forth in Notice section 5.02, which states that:

> Notwithstanding section 5.01, if a life insurance contract satisfied section 4.01 or 4.02 [of the Notice] when originally issued, a change from previous tables to the 2001 CSO tables is not required if (1) the change, modification, or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract; (2) the state in which the contract is issued does not require use of the 2001 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and (3) the contract continues upon the same policy form or blank.

Notice section 5.03 then goes on to identify examples of changes that fall within the scope of Notice section 5.02, stating:

> The changes, modifications, or exercises of contractual provisions referred to in section 5.02 include (1) the addition or removal of a rider; (2) the addition or removal of a qualified additional benefit (QAB); (3) an increase or

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decrease in death benefit (whether or not the change is underwritten); (4) a change in death benefit option (such as a change from an option 1 to option 2 contract or vice versa); (5) reinstatement of a policy within 90 days after its lapse; and (6) reconsideration of ratings based on rated condition, lifestyle or activity (such as a change from smoker to nonsmoker status).

The rule set forth in Notice section 5.02 is an alternative to the rule set forth in section 5.01 of the Notice, and thus it is only necessary to satisfy one of the rules (rather than both) to avoid new issue treatment on account of a policy change for purposes of the Notice. This being said, sections 5.01 and 5.02 of the Notice largely overlap, since the latter rule mirrors the DEFRA Option Rule. An interesting question, then, is whether, or in what respects, the DEFRA Option Rule differs from the requirement of Notice section 5.02(1). As discussed above, the DEFRA Option Rule generally treats changes as not causing a policy to be newly "issued" if the change is made pursuant to a contractual right. In contrast, Notice section 5.02(1) refers to a "change, modification, or exercise of a right to modify, add or delete benefits [that] is pursuant to the terms of the contract."

Only the reference to "exercise of a right" in Notice section 5.02 mirrors the DEFRA Option Rule, and in using the disjunctive, it appears that a "change" or "modification" seemingly would not necessarily need to represent the exercise of a right. If this is not the case, then use of those words seemingly would be redundant. At the same time, it seems clear that a "change," "modification," and "exercise of a right" must all be "pursuant to the terms of the contract" in order to fall within the ambit of the rule. Thus, arguably, if the terms of a policy contemplate that a particular bilateral change might be made (such as the later addition of a rider), such a change would be "pursuant to the terms of the contract" even though the owner could not have unilaterally made the change. While this argument has merit (especially where agreed upon rules or an ascertainable standard will govern the later change), it is also reasonable to construe the words "pursuant to the terms of the contract" as connoting the exercise of a unilateral contractual right. Thus, while Notice section 5.02 has helped resolve the consequence of many types of policy changes—including some of the more important ones, such as underwritten increases in benefits pursuant to a contractual right[80] —there continues to be uncertainty with respect to other types of changes where the insurer has discretion to deny an owner's request for the change.[81]

Some question has arisen in connection with Notice section 5.03, which as set forth above provides examples of changes, modifications, and exercises of contractual provisions that are described in Notice section 5.02. In particular, the examples include some changes, such as "the addition … of a rider," for which there commonly is no contractual right to make the change, and many policies may not even discuss the possibility that riders could later be added. In this circumstance, should one look to the operative rule (Notice section 5.02) and if its conditions are not met conclude that the change would cause a policy to be newly issued for purposes of the Notice? Or should inclusion of a change in Notice section 5.03 be conclusive that the change is not one that causes the policy to be newly issued? If the former view controls, there is perhaps a silver lining in that one of the examples in Notice section 5.03 is a "reinstatement of a policy within 90 days after its lapse." The reference to 90 days may perhaps have been intended to mirror the reinstatement rule of section 7702A(c)(2)(B), although this is unclear. What is clear, however, is that many policies expressly provide owners with a contractual right to reinstate their coverage for a period longer than 90 days. Where this is the case, such a reinstatement would clearly seem to fall within the ambit of Notice section 5.02, and the fact that the example does not describe this circumstance can be viewed as irrelevant. Absent further guidance, the precise nature of the relationship between Notice sections 5.02 and 5.03 will likely remain undefined.[82]

While Notice 2006-95 has helpfully resolved many questions about certain common changes, such as underwritten death benefit increases pursuant to a contractual right, other questions persist. One common change that has raised questions is a change in the guaranteed rating or smoking status for a policy. In some cases (perhaps most), the owner may have a right to make the change, *e.g.*, either as a matter of contract law or because an insurer's denial of the change would violate state law non-discrimination requirements, so that the DEFRA Option Rule (and Notice section 5.01 or 5.02) should apply.[83] Where there is no such right, however, odd—and potentially very harsh—results could arise from treating the policy as newly issued for purposes of the Reasonable Mortality Rule. Initially, it should be kept in mind that absent the grandfather issue, a change from smoker to nonsmoker status or the elimination or reduction in a substandard rating generally would result in an adjustment event under section 7702(f)(7)(A) which would *reduce* the guideline premiums and net single premiums of the policy (*i.e.*, "proper adjustments" would be

made to reflect the change). Also, these are not changes that owners would make with any intention of increasing the investment orientation of a policy. Rather, they are made to reduce the cost of a policy, in reflection of the insured's change of lifestyle (*e.g.*, cessation of smoking) or otherwise improved health.

If the change causes the policy to be newly "issued," however, it may be necessary to reapply section 7702 using a completely different mortality table that is unrelated to the policy's guarantees (*e.g.*, 2001 CSO versus 1980 CSO). Thus, a change in mortality guarantees having nothing to do with increasing the policy's investment orientation, and which could be readily accounted for using the adjustment rule, could subject the policy to entirely new tax requirements that the parties could not have contemplated upon the actual issuance of the policy. A possible response to this concern may be that, upon a bilateral change, the parties can further agree to make changes in order to satisfy new tax requirements, but this is unrealistic. If calculations under section 7702 are required to be based on new mortality tables, it often would be necessary to disgorge monies from the policy in order to maintain compliance, even though those same monies may be necessary to keep the policy in force based on the policy's guarantees. It also would be problematic to allow smoker status and rating changes generally but to impose material conditions as a prerequisite to making such changes for a subset of policies. In addition, changing the section 7702 calculations for a subset of policies often would be impractical for computer-based administrative systems. The reality is that, where such material change issues are presented, insurers will simply refuse to permit changes, even where they commonly permit such changes absent the loss of grandfathering concern. If further guidance could be obtained that targeted limited circumstances of bilateral changes such as changes in smoker status and ratings, this would be a helpful clarification of permissible practices in this regard.

As a final comment regarding Notice section 5, it is important to bear in mind that this provision applies only "[f]or purposes of the Notice." The scope of the Notice, in turn, largely focuses on the three safe harbors of Notice section 4. While Notice section 2, identified as "Background," describes the fact that 2001 CSO became the prevailing mortality table in 2004 and further states that "[f]or contracts issued after 2008, use of the 2001 CSO tables will be mandatory," these statements merely reflect the applicable law, and thus it does not appear that the material change rules of Notice section 5 were intended to apply except for purposes of the safe harbors. If they were construed to apply for all purposes, this could affect the analysis presented above regarding the Reasonable Charge Effective Date Rule and when changes cause a loss of grandfathering under this rule. Such a construction also would be problematic in that new "issue" treatment might take precedence over the adjustment rule of section 7702(f)(7)(A), which as discussed above seems inappropriate for a policy already subject to section 7702.[84]

SECTION 7702A(c)(3) MATERIAL CHANGE RULE

Section 7702A defines a MEC as a policy that either fails to satisfy the 7-pay test of section 7702A(b) or is received in exchange for a policy that already was a MEC. The statute includes two rules to address changes in the terms or benefits of a policy. The first, set forth in section 7702A(c)(2)(A), is the so-called "reduction in benefits rule," which provides that: "If there is a reduction in benefits under the contract within the 1st 7 contract years, [section 7702A] shall be applied as if the contract had originally been issued at the reduced benefit level."[85] The second, appearing in section 7702A(c)(3)(A), is a material change rule which provides that:

> If there is a material change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination under [section 7702A], for purposes of [section 7702A] –
>
> (i) such contract shall be treated as a new contract entered into on the day on which such material change takes effect, and
>
> (ii) appropriate adjustments shall be made in determining whether such contract meets the 7-pay test of [section 7702A(b)] to take into account the cash surrender value under the contract.

(Herein, this rule is referred to as the "7702A Material Change Rule.") Where there has been a change in a policy's terms or benefits which is a reduction in benefits, the legislative history of section 7702A confirms that the reduction in benefits rule applies instead of the 7702A Material Change Rule.[86]

Apart from changes that constitute reductions in benefits, determining whether a change in a policy's terms or benefits results in a material change for purposes of the 7702A Material Change Rule can be thought of as a two-step analysis. The first part—and the one on which this article will focus—is

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whether the change constitutes a "change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination under [section 7702A]" within the meaning of section 7702A(c)(3)(A). In this regard, section 7702A(c)(3)(B) clarifies that for purposes of the 7702A Material Change Rule, "the term 'material change' includes any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract." The second part of the analysis is whether material change treatment is deferred by reason of the so-called necessary premium test of section 7702A(c)(3)(B)(i) (the "NPT").[87] As an example of the application of these rules, any death benefit increase, including those under so-called option 2 death benefits, will result in a material change under the first part of the analysis, but the NPT may apply to defer (perhaps permanently) the recognition of a material change due to such increase.

Ultimately, use of a consistent approach is perhaps the touchstone of most importance—and the garlic and salt needed to repel unwelcome spirits.

The 7702A Material Change Rule is triggered by changes in much the same way that the adjustment rule of section 7702(f)(7)(A) is triggered. In particular, each of these rules examines whether changes have been made to a policy's benefits or terms that are inconsistent with the calculations previously made under the applicable statute.[88] Thus, since section 7702A(c)(3)(A) generally requires material change treatment for a "material change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination under [section 7702A]," it is necessary to examine the policy's current terms and benefits and ascertain whether they are different from those previously reflected (in some manner) in the prior calculation of the section 7702A 7-pay premiums. If they are different (and cannot be characterized as reductions in benefits), then the policy must be treated as newly "entered into" for purposes of applying section 7702A, subject to the NPT. Implicitly, it would seem that the only changes that are relevant are ones that would affect calculations of the 7-pay premiums in the first instance (assuming there is no fundamental change to the policy, such as where the policy is treated as entirely new under state law).

Uncertainty often arises, however, as one tries to implement these requirements. For example, if a QAB is added to a policy, this would seem clearly to give rise to a material change (subject to application of the NPT). However, what if the insurer generally does not reflect QAB charges in 7-pay calculations? Can it then choose to ignore the QAB addition? Does it matter whether the QAB is added during versus after a 7-pay period? If the insurer consistently ignores QABs (or certain QABs) for purposes of calculating 7-pay premiums, it would seem that it should be permissible to do so consistently, although no guidance has confirmed this.[89] Given the complexity of the statute, the lack of guidance on many points, and the burden of designing administrative systems to apply these rules, flexibility arguably should be permitted to allow for some conservatism in establishing the limitations under sections 7702 and 7702A, even if the approach adopted is not conservative in all circumstances (*e.g.*, due to the attained-age decrement method as applied to decreases in benefits). Ultimately, use of a consistent approach is perhaps the touchstone of most importance—and the garlic and salt needed to repel unwelcome spirits.

Consider also the circumstance in which a policy is issued with guaranteed cost of insurance ("COI") charges that reflect the insured's status as a smoker or which reflect a substandard rating, but then the guaranteed COI charges are reduced to those that would apply for a nonsmoker or the substandard rating is removed. If the lower COI charges had applied at issue, lower 7-pay premiums would have been calculated. However, a reduction in COI charges is not a reduction in "benefits," and thus the reduction in benefits rule of section 7702A(c)(2) would appear to be inapplicable. This leaves only the possibilities of treating the change as a material change or disregarding it altogether. Because the change affected the COI charges reflected in the prior 7-pay premium calculation, it is difficult to conclude under the literal terms of the 7702A Material Change Rule that it should be ignored. From a tax policy perspective, however, the change is not one that realistically would be associated with any attempt to increase the investment orientation of a policy. What perhaps would make the most sense would be to adjust the 7-pay premiums in some manner for the remainder of the 7-pay period so that they would be based only on the new guaranteed COI charges (assuming they satisfy the reasonable mortality requirements), but the statutory framework does not appear to contemplate such a result. Similarly, if a policy is outside of a 7-pay period, it would seem appropriate from a tax policy perspective simply to ignore the change; however, again, the statute would seem to compel material change treatment in the absence of published guidance that prescribes a more reasonable result.

MATERIAL CHANGES UNDER SECTION 264(f)

Section 264(f) was enacted by section 1084 of the Taxpayer Relief Act of 1997 (the "1997 Act")[90] and is effective for policies issued after June 8, 1997, in taxable years ending after such date.[91] Section 264(f) imposes restrictions on the deductibility of interest by a business taxpayer that owns or benefits from certain life insurance policies, even though such interest does not relate to borrowing with respect to those policies.[92] Specifically, section 264(f)(1) provides that "no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash values."[93] Section 264(f)(4)(A), however, provides an exception from the interest deduction disallowance rule with respect to any policy owned by an entity engaged in a trade or business that covers an individual who is a 20 percent owner of the entity or is an officer, director or employee of the trade or business "at the time first covered by the policy" (referred to herein as a "Permitted Insured").[94]

Potential Loss of Grandfathering for Policies Issued Before June 9, 1997

The effective date rule for section 264(f) provides that "any material increase in the death benefit or *other material change* in the contract shall be treated as a new contract except that … the addition of covered lives shall be treated as a new contract only with respect to such additional covered lives."[95] On its face, this "material increase in the death benefit" provision of the section 264(f) transition rule appears very broad in scope, so that most death benefit increases seemingly would cause a policy issued on or before June 8, 1997, to become subject to section 264(f). For example, it seems likely that any increase in a policy's face amount, whether or not underwritten, that results from an owner's request would be encompassed by the rule. Other death benefit increases likely encompassed by the rule include those with respect to which the insurer has reserved the right to require evidence of insurability, *e.g.*, where the insurer may require such evidence prior to application of a premium payment that causes an increase in death benefit. In contrast, increases due to premiums and interest credits for which no underwriting is required (such as those under an option 2 death benefit, section 7702 corridor-based increases and certain paid-up additions) arguably should not be considered "material," since they reflect the original death benefit structure and occur automatically. Due to the lack of guidance, however, the scope of the section 264(f) transition rule is unclear, and care especially should be exercised in any case where an owner's action results directly or indirectly in a death benefit increase.

The section 264(f) transition rule also provides that any "other material change" in a policy issued on or before June 8, 1997, will cause it to be considered as a new policy and thus subject to section 264(f). While the scope of this part of the transition rule is also unclear, it would seem that material change principles similar to those described in the legislative history with respect to the Section 7702 Effective Date Rule, including the DEFRA Option Rule, would be pertinent for this purpose.[96] In this connection, the IRS said in Notice 2008-42[97] that a change to a split dollar arrangement that does not affect the terms of a life insurance policy will not be considered a material change for purposes of section 264(f) or section 101(j) (discussed below).

Risk that Section 264(f) Would Be Reapplied

If a policy was originally issued after June 8, 1997, section 264(f) would have applied to the policy when it was issued. However, a continuing issue for such a policy is whether a change after issue causes it to be treated as a new policy for purposes of section 264(f), so that section 264(f) newly applies to the policy. The possibility of new policy treatment is relevant because it could affect the applicability of the exception in section 264(f)(4) for a policy covering a Permitted Insured. While this exception to application of section 264(f) generally applies to a policy covering an individual who is a Permitted Insured "at the time first covered by the policy or contract," the exception would no longer apply to the policy if it was treated as a new policy and the insured no longer was a Permitted Insured at the time that new policy is deemed to arise.

In Revenue Ruling 2011-9,[98] the IRS held that, upon a tax-free exchange of policies under section 1035, section 264(f)(4) would need to be reapplied and that, in consequence, the section 264(f)(4) exception would no longer apply if the covered insured no longer was a Permitted Insured (*e.g.*, if he or she was only a former or inactive employee at the time of the exchange).[99] In this respect, the IRS stated that "[i]n general, a contract that is received in exchange for an existing contract is treated as a new contract issued on the date of the exchange for purposes of testing the contract's qualification as a life insurance contract under § 7702." [100] The Ruling also noted that the TAMRA Conference Report, in describing the application of section 7702A, stated that "[c]onsistently, the exchange of a life insurance contract for another life insurance contract is

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treated as a material change, and the contract received in the exchange is treated as a new contract, for purposes of applying the 7-pay test of § 7702A(b) to determine whether the contract is a modified endowment contract (MEC)."

Apart from actual exchanges, the law is unclear regarding the standard to apply for purposes of ascertaining whether particular changes to policies can cause section 264(f)(4) to be reapplied. On the one hand, it may be that the transition rule associated with the effective date of section 264(f) continues to apply, so that a "material increase in the death benefit or other material change" within the meaning of that rule at any time will cause section 264(f) to apply anew to the policy. Under this view, the discussion above regarding material increases in death benefits would need to be applied on an ongoing basis. The consequence is that changes to the death benefit under policies would largely need to be restricted, or else it would be necessary to re-qualify for the section 264(f)(4) exception at the time of any such change in order to avoid application of section 264(f)(1). On the other hand, it may be that general material change principles under the tax law—such as is reflected by the legislative history of the Section 7702 Effective Date Rule, including the DEFRA Option Rule[101]—should govern whether a policy is newly "issued" so that a policy must re-qualify under section 264(f)(4).

It is also worth noting, in this context, that if there is an ownership change, two other issues could arise. First, if the policy is already subject to section 264(f), a change in ownership could be problematic if the entity that becomes the new owner was not the employer of the insured (or if the entity does not have another relationship with the insured that meets the exception in section 264(f)(4)) at the time the insured first became covered by the policy. Second, a change in ownership could bring the policy within the transfer for value rule under section 101(a)(2) if the new owner does not retain a "carryover" basis in the policy. There is, however, one bit of good news: a change in ownership of a policy is generally not treated as a material change.[102]

MATERIAL CHANGES UNDER SECTION 101(j)

Section 101(j), which was enacted by section 863 of the Pension Protection Act of 2006 (*i.e.*, the PPA),[103] generally limits the exclusion from income accorded to life insurance death benefits under section 101(a)(1) in the case of an "employer-owned life insurance contract." In particular, section 101(j)(1) provides that "in the case of an employer-owned life insurance contract, the amount excluded from gross income of an applicable policyholder by reason of [section 101(a)(1)] shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract." This general rule will not apply, however, where an exception in section 101(j)(2) is met (*e.g.*, for an insured who is a "highly compensated" person) and certain notice and consent requirements under section 101(j)(4) are met.

Potential Loss of Grandfathering for Policies Issued Before Aug. 18, 2006

Section 101(j) generally is effective for policies issued on and after Aug. 18, 2006, subject to certain special rules. In this regard, section 863(d) of the PPA provides that any policy issued on or after Aug. 18, 2006, in a section 1035 exchange will not be subject to the new rules. At the same time, the very same transition rule goes on to state that "any material increase in the death benefit *or other material change* shall cause the contract to be treated as a new contract" for purposes of the effective date rule. (Emphasis added.) In commenting on the transition rule, the legislative history of the PPA states that:

> [C]ertain material increases in the death benefit or other material changes generally cause a contract to be treated as a new contract, with an exception for existing lives under a master contract. Increases in the death benefit that occur as a result of the operation of section 7702 of the Code or the terms of the existing contract, provided that the insurer's consent to the increase is not required, will not cause a contract to be treated as a new contract. In addition, certain changes to a contract will not be considered material changes so as to cause a contract to be treated as a new contract. These changes include administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued.[104]

Also, Q&A-14 of Notice 2009-48[105] mirrors this legislative history by stating that "[t]he following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of § 101(j): (1) increases in death benefit that occur as a result of either the operation of § 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required[106]); (2) administrative changes; (3) changes from general account to separate account or from separate account to general account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued."

An initial question with respect to the section 101(j) transition rule regards the standard that should be used to determine whether there is an "other material change." Similar to the analysis under section 264(f), it would seem that general material change principles—such as is reflected by the legislative history of the Section 7702 Effective Date Rule, including the DEFRA Option Rule—should apply. A source of uncertainty, however, lies in the curious relationship between the transition rule protecting section 1035 exchanges from new issue treatment and the further transition rule treating a material change as resulting in a newly issued policy. Reconciling these two rules is somewhat problematic in that, normally, an exchange is considered a material change. It may be that the rules could be reconciled by construing the section 1035 rule as controlling *only* if there otherwise is no material change (apart from the identity of the issuer) between the policy given in the exchange and the policy received in the exchange. Such a view arguably would require, *inter alia,* identical guarantees with respect to mortality and expense charges and interest guarantees. This also is problematic, however, since in most cases some material difference will exist between life insurance policies given up and received in an exchange, and it would seem improper as a matter of statutory construction to construe the exchange provision in so limited a manner that it never would apply as a practical matter. At the same time, interpreting the relationship between these rules otherwise could be viewed as undermining the material change portion of the transition rule. Regarding this question, Q&A-15 of Notice 2009-48 states that "[a] § 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) is treated as the issuance of a new contract after August 17, 2006 for purposes of determining whether § 101(j) applies to the contract." This Q&A seems to provide that the material change portion of the transition rule will be controlling, although this arguably does not satisfactorily resolve the conundrum of imparting a meaningful role for the section 1035 portion of the transition rule.

Risk that Section 101(j) Would Be Reapplied

As noted above, if a policy is subject to section 101(j), the section 101(a)(1) exclusion from gross income for death benefits is restricted in the case of death benefits paid under an "employer-owned life insurance contract" unless an exception and certain notice and consent requirements under section 101(j)(2) and (4) are met. Also, section 101(j)(4) provides that its notice and consent requirements must be satisfied "before the issuance of a contract." In light of this, it seems that if a change causes a policy to be treated as newly issued, it would be necessary to satisfy the notice and consent requirements again (seemingly before the change), even if those requirements previously had been satisfied prior to the original issuance of the pre-change policy.[107] Thus, when a change to a policy that is already subject to section 101(j) (and which meets the section 101(j)(4) exception) is being contemplated, it is necessary to consider whether the change might cause the policy to be treated as newly issued for purposes of section 101(j).

Similarly to the discussion above in the context of section 264(f), the standard that applies to determine whether a change causes a policy to be treated as newly issued under section 101(j) is unclear. For example, it may be that the same transition rules that governed the original effective date of section 101(j) should apply. Alternatively, general material change standards arguably should dictate whether a change results in a newly issued policy for this purpose.

MATERIAL CHANGES UNDER SECTION 848

Section 848(a) requires insurers to capitalize policy acquisition expenses for "specified insurance contracts" based on a percentage of "net premiums" received under such contracts (this is known as the "DAC tax"). The term "net premiums" with respect to any category of specified insurance contracts generally is defined as gross premiums and other consideration under such contracts reduced by return premiums and the net negative consideration for certain reinsurance agreements.[108] The regulations under section 848 set forth requirements for calculating the gross amount of premiums received in the event of certain "internal" exchanges, *i.e.*, exchanges of policies involving the same insurer, as well as "external" exchanges, *i.e.*, where a policy issued by one insurer is exchanged for a policy issued by another insurer.

In particular, these regulations provide that "[i]f a contract is exchanged for a specified insurance contract issued *by another insurance company*, the company that issues the *new contract* must include the value of the new contract in the gross amount of premiums and other consideration."[109] In other words, the DAC tax is applied to the issuer of the new policy upon such exchange. In contrast, in the case of an internal exchange, the regulations provide in relevant part:

> If a contract is exchanged for a specified insurance contract issued by the same insurance company that issued the

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original contract, the company must include the value of the new contract in the gross amount of premiums and other consideration if the new contract ... *[c]hanges the interest, mortality, morbidity, or expense guarantees* with respect to the nonforfeiture benefits provided in the original contract.[110]

While this rule contains an exception for changes in temporary guarantees,[111] an internal exchange that results in a permanent change with respect to the calculation of a policy's nonforfeiture benefit (*i.e.*, its cash value),[112] including a change in the interest rate guarantee used to determine such nonforfeiture benefit, is treated as giving rise to a new policy, so that the DAC tax would be reimposed with respect to such policy. This amounts to a special version of a material change rule, and unlike the material change concepts previously discussed herein, it generally is well spelled out in black-letter law. This renders it somewhat distinct.

Another common thread in the IRS guidance is that changes not affecting the computation of the Code's limitations generally are not considered material changes.

SURVEY OF OTHER GUIDANCE PERTAINING TO POLICY CHANGES

To summarize our discussion thus far:

- In considering the effect of a change to a life insurance policy, it frequently is necessary to apply general material change principles under the tax law, and in this regard *Cottage Savings* and the legislative history of the Section 7702 Effective Date Rule, including the DEFRA Option Rule, provide a good starting point for the analysis.

- In connection with the DEFRA Option Rule, moreover, it generally is necessary to examine whether a change is made pursuant to an existing contractual right.

- Normally, it will be the owner of the policy who possesses such a right, although in other cases it is the insurer who has a right to make a change. Also, under state law, insurers may in some instances unilaterally make a change if it will not be to the disadvantage of policy owners.

- For tax purposes, sometimes it may matter which party initiates the change, *e.g.*, as reflected in the legislative history for the section 7702(f)(7)(A) adjustment rule, which provides that adjustment events generally do not arise from a change unilaterally made by the insurer.[113]

In view of the last mentioned distinction regarding the initiator of the change, the survey of the IRS guidance below (some published, some non-precedential, but not previously discussed in this article) has been organized by first addressing company-initiated changes and then policyowner-initiated changes. Much of the guidance involving company-initiated transactions relates to rehabilitations. In these special circumstances the rights and obligations of the parties to a policy may be modified pursuant to state regulatory action, and in these instances the IRS generally has concluded that changes are not material. Another common thread in the IRS guidance is that changes not affecting the computation of the Code's limitations generally are not considered material changes.

Company-Initiated Changes

Guidance on company-initiated changes also falls into two categories: changes in the obligor (the insurance company) under policies, and changes to the terms and benefits of policies. The rulings involving a change of obligor have generally concluded that such changes do not affect the "issue date" and "entered into" date of policies if the terms of the policies do not change. This is even though these transactions change the identity of one of the parties to the policy.[114]

Reinsurance. In a series of private letter rulings issued in 1990 (and one in 1986) addressing assumption reinsurance transactions, the IRS held that so long as the proposed substitution of the reinsurer for the original insurer was the only modification made, policies would not be considered newly issued for purposes of sections 101(f), 264(a)(4), 264(c)(1) (now 264(d)(1)), 7702 and 7702A.[115] The IRS explained: "An assumption reinsurance agreement is not initiated by the policyholder and does not result in a change of the existing contractual obligations of the underlying life insurance policy. It merely allows the obligation of the original insurer under the existing policies to be assumed by the reinsurer."[116] Similarly, in PLR 9407019 (Nov. 19, 1993), the IRS ruled that a reinsurance transaction between a foreign insurer and its wholly owned domestic insurer would not affect the date a policy was issued, entered into, or purchased for purposes of sections 101(f), 264(a)(4), 7702 and 7702A, among others, and that the IRS would not require retesting or the start

of a new test period under sections 264(c)(1), 7702(f)(7)(B) through (E), and 7702A(c)(3)(A). In this ruling, the foreign insurer remained secondarily liable under the contracts. In issuing this ruling, the IRS noted that the reinsurance agreement is not initiated by the policy owner and does not result in a change of the existing contractual obligations of the underlying life insurance policies.

Liquidation of a Subsidiary. Where a subsidiary is liquidated into a parent company, blocks of policies issued by the subsidiary may be assumed by the parent company without affecting the date the policies were issued, entered into, or purchased for various federal tax purposes, including under sections 101(f), 264(f), 7702 or 7702A.[117]

Demutualization. The conversion of a mutual insurance company to a stock life insurance company will not affect the date each life insurance policy of the mutual company was issued, entered into, purchased, or came into existence for purposes of sections 101(f), 264, 7702 and 7702A.[118]

Rehabilitation of a Company. Rev. Proc. 92-57[119] provides guidance regarding the consequences of modifications and restructurings of life insurance, annuity and endowment policies due to the rehabilitation of the insurer. This revenue procedure provides administrative relief for taxpayers by treating the modifications or restructuring of life insurance, annuity or endowment policies issued or assumed by an insurance company in connection with a rehabilitation, conservatorship, insolvency or similar state proceeding as not resulting in a loss of policies' grandfathered status for purposes of sections 72, 101(f), 264, 7702 and 7702A and as not requiring retesting or the beginning of a new test period under sections 264(c)(1), 7702(f)(7)(B)-(E) and 7702A(c) if certain conditions are met.[120]

If a block of policies falls into this category, significant changes to existing contractual obligations are permitted without causing a policy to lose its grandfather status. Specifically, Rev. Proc. 92-57 states that "[m]odification or restructuring may include, but is not limited to, reductions in benefits, adjustments to mortality or other expense charges, reductions in the rate of interest credited to the contract, and restrictions on the policy owner's ability to receive benefits under the affected contract." But for the revenue procedure, these changes would typically be treated as material changes and could cause a loss of grandfathering, at least in some contexts.

Addition or Reallocation of Investment Options. The IRS has ruled that the addition of an investment option under a non-variable life insurance policy was not a material change since it did not involve a change in any benefit or other term of the policy that was not reflected in any previous determination under sections 7702 or 7702A.[121] In a similar ruling regarding an amendment to a variable life insurance policy allowing the owner to allocate the policy's investment base to additional investment divisions, the IRS cited to the DEFRA Senate Report and reasoned that the amendment would not result in a deemed exchange since the amendment did not affect the material elements of a policy as identified in that Report, *i.e.*, the amount and pattern of death benefit, the premium pattern, guaranteed interest rates, mortality and expense changes, and other values affecting the policy's actuarial structure.[122]

Change of Policy Loan Provisions. As noted above, the legislative history of the Section 7702 Effective Date Rule states that a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange.[123] In commenting on this, the IRS has stated that a "change in the loan interest from being due in advance to being due in arrears and the corresponding interest rate change (which will not result in the Policyholders receiving a time value of money benefit) is merely a minor administrative change."[124]

Sale with Section 338 Election. The IRS also has held that a section 338 election upon the sale of a life insurance company's stock to another life insurance company does not result in a material change to the life insurance policies of the issuing company.[125]

Policy-Owner-Initiated Changes

While some changes might be thought of as insurer-initiated (such as in CCA 200805022, discussed above, since the insurer took the first step in permitting certain changes), they could also be thought of as policy-owner-initiated in that the policy owner chooses whether to implement the changes. This may be true as well of certain of the changes involved in Notice 2006-95, as discussed above. The fact that changes often involve action by both parties raises a question, however, with respect to the timing of certain material changes.

If the insurer's action merely involves an administrative practice, and no change is made to a policy's terms and benefits

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until the policy owner takes some subsequent action, it would seem that no change is made until the policy owner's action occurs. The answer is less clear, however, if an amendment or endorsement is made to a policy to permit a change by a policy owner. Which is the triggering event, assuming that one must be treated as a material change for some purpose: the insurer's action or the policy owner's later action? Certainly, if the amendment or endorsement was made prior to a statutory effective date, one could readily conclude that a contractual right to make the change existed on that effective date. However, if the amendment or endorsement was added after the effective date, arguably no material change should arise until the policy change is actually effected, *i.e.*, by the policy owner's action.

Policy-owner-initiated changes that have been the subject of guidance can be thought of as falling into one of three types: (1) assignment or movement of policies; (2) changes pursuant to the terms of a policy (*e.g.*, as described by the DEFRA Option Rule or in Notice 2006-95, discussed above); or (3) changes permitted by administrative practice.

Contract Exchanges. As discussed in more detail above, Rev. Rul. 2011-9 [126] addresses the exchange of life insurance policies in the context of section 264(f)(1). Section 264(f) denies interest deductions for owners of corporate-owned and bank-owned life insurance policies (COLI and BOLI, respectively), unless the policies cover the lives of individuals who were employees, officers or directors of the policyholder "at the time first covered" by the contracts. As indicated above, the ruling provides that the "at the time first covered" exception must be re-applied if the policy is exchanged in a section 1035 exchange.

Assignment of Policies to a Trust. An assignment of a policy is treated differently than an exchange of a policy. In the case of an assignment, the policy's terms and benefits remain unchanged. In PLR 9109018,[127] the IRS noted the following facts: (a) an employer's beneficial interests in policies did not change upon assignment of the policies to the trustee of the trust; (b) the employer's interest in a policy could not be used to satisfy a plan obligation for which another employer is primarily liable unless the employer agrees that its interest be so used; (c) upon an employer's insolvency only its interest in a policy can be used to satisfy the claims of its creditors; and (d) the trust remains a grantor trust at the time of the assignment. Based on these facts, the IRS concluded that "[t]he assignment does not of itself cause the Policies to be entered into after June 21, 1988, for purposes of the effective date provisions of section 7702A of the Code."

Partition of a Policy. The IRS also has ruled on the partition of life insurance policies.[128] In companion rulings, a policy owner had engaged in a spin-off transaction that was treated as tax-free under sections 355 and 368 and wanted to partition the group life insurance policy it had held before the spin-off so that the interest in the policy could be held separately by two entities. In particular, the original group policy was replaced with two separate group policies, and each original certificate of insurance was replaced with two certificates of insurance. The IRS concluded that: "There will be no material change between the Original Certificates and the Separate Certificates because the sum of the benefits under the Separate Certificates is equal to the sum of the benefits under the Original Certificates and the terms of the Original Certificates are identical to the terms of the Separate Certificates." Interestingly, the rulings conclude that there is no adjustment event under section 7702(f)(7)(A) or material change under section 7702A(c)(3); treat the policies as having the same issue, purchase and premium paid dates for purposes of section 264, and treat the transaction as not causing a reapplication of section 264(f)(4); and divide the "investment in the contract" under section 72(c)(1) and (e)(6) between the new policies.

OVERARCHING PRINCIPLES AND FUTURE GUIDANCE

The discussion of material changes in the legislative history of section 7702 anticipated the Supreme Court's later analysis in *Cottage Savings*—in each case concluding that a material change to property may cause it to be viewed as a new property for tax purposes, with further consequences flowing from such characterization. At the same time, Congress generally applies new laws only prospectively, and thus there is a clear congressional intent that existing contractual relationships not be unduly upset.[129] Also, in the context of sections 101(f), 7702 and 7702A, general material change principles of the tax law often are clearly supplanted by statutory rules which more specifically address the proper treatment of changes to a life insurance policy. Thus, for example, while the legislative history of the Section 7702 Effective Date Rule, including the DEFRA Option Rule, applies for purposes of determining whether a change to a pre-DEFRA policy causes it to become subject to section 7702, the adjustment rule of section 7702(f)(7)(A) generally should control the treatment of policy changes

once a policy already is subject to section 7702. Also, while somewhat less clear, it would seem that the adjustment rule of section 101(f)(2)(E) similarly should govern the treatment of changes to policies subject to section 101(f). Under the same reasoning, the specific rules for policy changes under sections 7702A(c)(2), (3) and (6) should generally govern the application of section 7702A rather than the MEC Effective Date Rule once a policy already is subject to section 7702A.

Beyond this, the further effective date rules of sections 7702 and 7702A—*i.e.*, the Reasonable Charge Effective Date and the MEC Effective Date Rule—are based on the date a policy is "entered into." As discussed above, it appears that this date generally refers to the date of contract formation and that insurers do not have discretion to use a different date. Also, in prescribing special rules in the context of the MEC Effective Date that treat certain changes as causing a policy to be newly "entered into" for purposes of the MEC Effective Date Rule, a strong implication arises that changes apart from those addressed by the special rules generally should not affect the "entered into" date for purposes of these effective date rules. This construction makes sense given that the mortality basis of a policy generally cannot be modified after policy issuance, and subjecting pre-TAMRA policies to the Reasonable Charge Rules often would cause policy failures under section 7702 or 7702A. It is also noteworthy that, even though the Reasonable Charge Rules targeted certain abuses (and it appears that use of an "entered into" standard was adopted in part to address such abuses), Congress deliberately did not extend express material changes rules, such as those applicable to the MEC Effective Date Rule, to the Reasonable Charge Effective Date Rule. These considerations, taken together, build a strong case for concluding that changes usually should not be viewed as affecting the "entered into" date of a policy for purposes of these effective date rules except where such treatment is specifically prescribed.

If Congress intended the TAMRA effective date rules to apply in this manner, one can reasonably ask whether the IRS's subsequent guidance on the Reasonable Charge Rules is consistent with this intent. In a sense, this involves a different question, since the TAMRA effective dates (*i.e.*, the Reasonable Charge Effective Date Rule and the MEC Effective Date Rule) are based on the "entered into" date of a policy, whereas the statutory rule in section 7702(c)(3)(B)(i) refers to the "issue date" of a policy. This being said, it would be odd to conclude that a change would not cause a policy to become subject to the Reasonable Charge Rule and yet to conclude further that, once a policy is so subject, the same change would result in a reapplication of such Rule to the policy. If it is thought necessary to reconcile these views, one can either conclude that changes readily cause pre-TAMRA policies to be newly "entered into" (which as discussed above seems improper as a matter of statutory construction) or conclude that the "issue date" of a policy normally should be unaffected by policy changes. While the legislative history associated with the Section 7702 Effective Date Rule addresses when changes may cause a policy to be newly "issued" for purposes of that Rule, this history arguably should not have been enshrined as the standard in this regard more generally (as it has been, at least in part, in Notice 88-128 and Notice 2006-95). Of course, it does not appear that it applies for purposes of interpreting "issue date" in all respects since, if it did, all bilateral changes to the material terms of policies would cause them to be newly "issued" with entirely new guideline premiums. Given the presence of the adjustment rules, this seems plainly incorrect.

Thus, one returns to the question of whether undue emphasis has been placed on the DEFRA legislative history for purposes of applying the Reasonable Charge Rule. This may well be the case. As a practical matter, this is of no concern in many cases where the changes occur pursuant to contractual rights. Indeed, the change that can have the most significant impact on the magnitude of investment under a policy—a death benefit increase, including an increase that can be made only with underwriting—usually has no effect on the issue date of a policy for this very reason. Beyond this, bilateral changes typically are made for reasons that have little to do with tax considerations, often are unrelated to mortality charges, and in any event can be accounted for under the adjustment rule of section 7702(f)(7)(A). If a bilateral change is made, for example, to an interest rate guarantee, the adjustment rule of section 7702(f)(7)(A) and the material change rule of section 7702A(c)(3)(A) are perfectly capable of accounting for that change consistently with the purposes of section 7702 and 7702A.[130]

Requiring a further change to the calculations under these statutes is unnecessary and often creates a substantial disincentive and chilling effect. A change from smoker to nonsmoker status—which of course does pertain to mortality—offers a good case in point: instead of making warranted changes and using the adjustment rule to account for the change (which would reduce guideline premiums and net single premiums), some insurers are refusing to permit the changes because of fear—a reasonable fear, we would add—that such actions will lead

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to failed life insurance policies. While one may appreciate the need for line drawing and of basing guidance on existing authorities, much good to insurers and policy owners, and no harm that we can perceive to the IRS, would come from some further clarifications to existing guidance. At a minimum, for example, it would be appropriate and helpful for the IRS to issue guidance providing that changes in guaranteed ratings and smoking status do not cause a policy to be newly issued for purposes of the Reasonable Mortality Rule. Still other guidance providing exceptions mirroring those of Treas. Reg. section 1.7702B-2(b)(4)(ii) would be appropriate, *e.g.*, that a reduction in death benefit or a QAB in all instances would not forfeit grandfathering. Further, if a change is made that would not affect the calculations under section 7702 or 7702A, the change should always be immaterial for purposes of the pertinent statute. The principles outlined herein would go even beyond these cases, but guidance that specifically addresses the most common changes to policies certainly would alleviate concerns and help allow insurers to administer policies in the manner they normally would absent concern about material change implications under these Code provisions.

Outside of the context of sections 7702 and 7702A, still more uncertainty exists. In the context of sections 264(f) and 101(j), this uncertainty derives in part from the fact that specific material change rules are incorporated into the effective date rules for these provisions, and also from the fact that there is no separate adjustment mechanism akin to section 7702(f)(7)(A) that can account for changes in a narrowly tailored manner. Thus, if a policy owner is potentially subject to these provisions, care should be taken in making changes to a policy, even ones which the owner has a right to make under the policy's terms (including death benefit increases in some instances).

The concept of material changes applies pervasively with respect to the federal tax treatment of life insurance policies, sometimes for definitions ("life insurance contract" and "modified endowment contract"), sometimes in ways that affect only a subset of policy owners (*e.g.*, the proration rules of section 264(f) and the COLI "best practices" rules of section 101(j)), and sometimes with respect to the insurer's own tax treatment (*e.g.*, under section 848 and otherwise under Subchapter L). Also, as shown in this article, there is considerable uncertainty in the law on many questions, and the stakes associated with incorrect treatment can be very substantial, *e.g.*, failed life insurance contracts, lost interest deductions, or limitations on the excludability of death benefits. And a further, perhaps troubling, thought is that, in one way or another, insurers have already resolved the issues described herein to the extent they have policies subject to the particular issues, in that they have taken positions in their current treatment of policies and related disclosures to policy owners. Truly it's a hobgoblin collection of ghoulies and ghosties to trouble the sleep of tax counsel, actuaries and IT professionals. It's something to consider the next time you pass a mainframe that administers all of these requirements, since of course that's where these poltergeists largely reside. ◀

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END NOTES

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

2 Material changes to a life insurance policy can have consequences under other Code provisions as well, *e.g.*, under section 807, which specifies rules for calculating reserves with respect to life insurance policies.

3 This article follows up on our discussion in the article *On Grandfathers and Adjustments: New IRS Chief Counsel Advice Memo Blurs Lines,* authored by John T. Adney, Bryan W. Keene and Craig R. Springfield, which appeared in the May 2008 issue of TAXING TIMES.

4 499 U.S. 554, 565 (1991). In the aftermath of *Cottage Savings*, the Department of the Treasury issued regulations which provided that any "significant modification" to the terms of a debt instrument would be deemed an exchange. Treas. Reg. section 1.1001-3(b). These regulations do not address changes made to life insurance policies. In regard to such policies, however, the preamble to the final regulations states that the "final regulations do not limit or otherwise affect the application of the 'fundamental change' concept articulated in Rev. Rul. 90-109 (1990-2 C.B. 191), in which the IRS concluded that the exercise by a life insurance policyholder of an option to change the insured under the policy changed 'the fundamental substance' of the contract, and thus was a disposition under section 1001." T.D. 8675, 61 FR 32930, June 25, 1996. In the context of debt instruments, the regulations define a "modification" as "any alteration, including any deletion or addition, in whole or in part of a legal right or obligation of the issuer or a holder of a debt instrument." Treas. Reg. section 1.1001-3(c)(1)(i). The regulations further state that a modification is significant "if based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." Treas. Reg. section 1.1001-3(e)(1). Also, a modification "that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations." Treas. Reg. section 1.1001-3(e)(4)(iv)(A).

5 As noted in the preamble to the final *Cottage Savings* regulations just quoted in note 4, the IRS observed in Rev. Rul. 90-109, 1990-2 C.B. 191, that any change to a life insurance policy, even one pursuant to an option provided in the policy, will result in an exchange if it is "a sufficiently fundamental or material change that the substance of the original contract is altered." As indicated above, this ruling involved a change of insured pursuant to a right set forth in the policy, which the IRS

concluded resulted in a deemed exchange. *Compare* Temp. Treas. Reg. section 1.1001-4T(a), which provides that the transfer or assignment of a derivative contract is not treated as a deemed exchange of the original contract for a modified contract that differs materially either in kind or extent if the transferor and transferee are dealers in securities or a clearinghouse, the terms of the derivative contract permit the transfer or assignment (whether or not the consent of the nonassigning party is required), and the terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under section 1001. 76 FR 43892 (July 22, 2011). *See also* TAM 9347005 (Aug. 10, 1993) (concluding that a section 1035 exchange occurred where policy owners accepted an offer (not provided under the pre-change policy) to add an endorsement which permanently increased the minimum interest rate guaranteed under the policy).

[6] *See, e.g.*, Rev. Rul. 2011-9, 2011-12 I.R.B. 554 (a section 1035 exchange gives rise to new life insurance policy for purposes of section 264(f)(1) and (4)(A)); PLR 200627021 (April 6, 2006) (same). In some cases, a deemed exchange due to a material change would not be protected by section 1035, *e.g.*, where the insured is changed. *See* Treas. Reg. section 1.1035-1. We note that private letter rulings cannot be cited as precedent or relied upon by taxpayers other than the taxpayer receiving the ruling. *See* section 6110(k)(3).

[7] This legislative intent also is reflected in section 7805(b), which generally restricts the retroactive application of regulations. *See also* UnionBalCal Corp. v. Comm'r, 305 F.3d 976, 987 (9th Cir. 2002) (addressing whether the IRS abused its discretion under section 7805(b), as in effect prior to July 30, 1996, in not retroactively applying a final regulation and stating that "[p]rospective application [of regulations] was reasonable to avoid disturbing transactions and tax returns based on what had been settled law"). A recent example of a prospective rule, and also of the application of material change principles, is provided by proposed regulations issued in connection with the Foreign Account Tax Compliance Act ("FATCA"). *See* Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, IRS REG 121647-10 (proposed Feb. 8, 2012) (77 FR 9022, Feb. 15, 2012). These proposed regulations implement the withholding requirements of section 1471(a) for certain payments to foreign financial institutions and generally provide that withholding is not required if the payment is made under a "grandfathered obligation" (which includes certain life insurance contracts outstanding on Jan. 1, 2013). *See* Prop. Treas. Reg. section 1.1471-2(a) and (b)(2)(i) and (ii). For this purpose, however, Prop. Treas. Reg. section 1.1471-2(b)(iii) states in part that: "Any material modification of an outstanding obligation will result in the obligation being treated as newly issued or executed as of the effective date of such modification." Also, Prop. Treas. Reg. section 1.1471-2(b)(iv) provides that: "In the case of an obligation that constitutes indebtedness for U.S. tax purposes, a material modification is any significant modification of the debt instrument as defined in §1.1001-3. In all other cases, whether a modification of an obligation is material will be determined based upon all relevant facts and circumstances."

[8] The material change rule of section 7702A(c)(3)(A) comes closest to following a deemed exchange approach, since a material change under this provision causes a policy to be treated as newly entered into. However, the rule reflects the existence of the pre-change policy in a number of respects. For example, section 7702A(c)(3)(A)(ii) provides for adjustments to the new 7-pay premium to reflect the cash surrender value of the policy at the time of the material change. Also, the so-called necessary premium rule of section 7702A(c)(3)(B) operates to defer material change treatment of certain changes to a life insurance policy.

[9] Similarly, as indicated above, *supra* note 6, in Rev. Rul. 2011-9 the IRS held that a section 1035 exchange gives rise to new life insurance policy for purposes of section 264(f)(1) and (4)(A).

[10] Section 863(d) of the Pension Protection Act of 2006, Pub. L. No. 109-280 (the "PPA"), provides that section 101(j) does not apply to a policy issued in a section 1035 exchange after the otherwise applicable effective date of the provision (Aug. 17, 2006), but then goes on to provide that a material increase in death benefit or other material change would cause a policy to be newly issued for purposes of this effective date rule. In regard to this rule, Q&A-15 of Notice 2009-48, 2009-24 I.R.B. 1085, provides that if there is a material increase in death benefit or other material change to a policy in connection with a section 1035 exchange, the policy is considered newly issued at the time of the exchange. This effective date rule is discussed in more detail below.

[11] Pub. L. No. 98-369 (1984).

[12] DEFRA section 221(a).

[13] Pub. L. No. 100-647 (1988).

[14] TAMRA section 5011(a) and (b).

[15] Certain other effective date rules also apply under section 7702. For example, section 7702(e)(2)(C), relating to policies purchased to cover burial expenses or in connection with prearranged funeral expenses, was added to section 7702 by the Tax Reform Act of 1986, Pub. L. No. 99-514 ("TRA"), and applies to policies entered into after Oct. 22, 1986. TRA section 1825(a)(4)(A)-(C); TAMRA section 1018(j).

[16] TAMRA section 5012(c) and (e)(1).

[17] As will be discussed below, TAMRA section 5012(e)(2) and (3) sets forth special rules regarding circumstances in which a change to an existing policy will cause it to be treated as newly "entered into" for purposes of the effective date of section 7702A.

[18] A detailed discussion of the manner of applying the adjustment rules of sections 101(f)(2)(E) and 7702(f)(7)(A) and the reduction in benefits and material change rules of section 7702A(c)(2), (3) and (6) is beyond the scope of this article. For further information on these subjects, see: CHRISTIAN J. DESROCHERS, JOHN T. ADNEY, DOUGLAS N. HERTZ, & BRIAN G. KING, LIFE INSURANCE & MODIFIED ENDOWMENTS: UNDER INTERNAL REVENUE CODE SECTIONS 7702 AND 7702A, 91-102 (1st ed. 2004); Letter from John H. Holt, American Council of Life Insurance (currently known as the American Council of Life Insurers), to Steven D. Hooe, IRS (April 3, 1995) (discussing the application of the attained-age increment and decrement method under section 7702(f)(7)(A)).

[19] *See* section 221(a) of DEFRA. Subject to certain exceptions, for contracts that provide an increasing death benefit and have premium funding more rapid than 10-year level premiums, section 7702 applies to contracts issued after June 30, 1984.

[20] Northwest Airlines v. Transport Workers Union, 451 U.S. 77, 91 (1981) ("In matters of statutory construction, it is appropriate to begin with the language of the statute itself"); Diamond v. Chakrabarty, 447 U.S. 303, 308, 315 (1980) ("In cases of statutory construction we begin … with the language of the statute…. [O]ur obligation is to take statutes as we find them, guided, if ambiguity appears, by the legislative history and statutory purpose"); Caminetti v. United States, 242 U.S. 470 (1917) ("It is elementary that the meaning of a statute must, in the first instance, be sought in the language in which the act is framed…").

[21] Atlantic Mut. Ins. Co. v. Comm'r, 523 U.S. 382 (1998); Evans v. U.S., 504 U.S. 255, 259-260 (1992); Gilbert v. U.S., 370 U.S. 650, 655 (1962); Morisette v. U.S., 342 U.S. 246, 263 (1952); U.S. v. Charles R. Allen Inc., Cust & Pat. App. 184 F.2d 846 (C.C.P.A. 1950), cert. denied 340 U.S. 818 (1951); Central Reserve Life Corp. v. Comm'r, 113 T.C. 19 (1999). In discussing the significance of technical terms, Justice Frankfurter commented:

> Words of art bring their art with them. They bear the meaning of their habitat whether it be a phrase of technical significance in the scientific or business world, or whether it be loaded with the recondite connotations of feudalism. Holmes made short shrift of a contention by remarking that statutes used "familiar legal expressions in their familiar legal sense." Henry v. United States, 251 U.S. 393, 395. The peculiar idiom of business or of administrative practice often modifies the meaning that ordinary speech assigns to language. And if a word is obviously transplanted from another legal source, whether the common law or other legislation, it brings the old soil with it.

47 COLUM. L. REV. 527 (1947).

[22] *See* COUCH ON INSURANCE 3D § 240:34 (2011), citing Mutual Life Ins. Co. v. Hurni Packing Co., 263 U.S. 167 (1923); Great Southern Life Ins. Co. v. Russ, 14 F.2d 27 (8th Cir. 1926); New York Life Ins. Co. v. Bullock, 26 F.2d 666 (5th Cir. 1928); Yates v. New England Mut. Life Ins. Co., 117 Neb. 265, 220 N.W. 285 (1928); and Prudential Ins. Co. v. Connallon, 108 N.J. Eq. 316 (1931). *Compare* DAN M. MCGILL (*revised* by BURKE A. CHRISTENSEN), MCGILL'S LIFE INSURANCE 769 (Edward E. Graves, et al. eds. 1994), which states that:

> The Policy may bear the date on which it was issued, the date on which the coverage becomes effective, or the date on which it was applied for. The most common practice is to date the policy as of the date of issue unless there is a conditional receipt. In this event the policy will bear the date of the application or the medical examination, whichever is later.

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[23] *See*, e.g., Suskind v. North American Life & Casualty Co., 607 F.2d 76 (3rd Cir. 1979) (stating: "Exposure of various abuses in the life insurance industry led President Theodore Roosevelt to call a conference in 1906 which recommended enactment of uniform life insurance laws. Included among the recommendations was the suggestion for a provision making the policy incontestable after two years from its issue date. This, in time, was adopted by most states. Shield, *A New Look at the Incontestability Clause*, 11 ASSOCIATION OF LIFE INSURANCE COUNCIL PROCEEDINGS 23, 32-36 (1952).").

[24] Temporary coverage often is limited in amount by guidelines specified by the insurer, and thus may be in an amount less than the coverage that will apply after issue.

[25] *See*, e.g., COUCH ON INSURANCE 3D § 14:2 (2011).

[26] *See*, e.g., MCGILL'S LIFE INSURANCE, *supra* note 22, at 759 (1994). *See also* Academy Life Ins. Co. v. Johnson, 206 Ga. App. 551, 426 S.E.2d 34 (Ga. App., 1992).

[27] BUIST M. ANDERSON, ANDERSON ON LIFE INSURANCE, section 9.3, at 286 (1991). See also MCGILL'S LIFE INSURANCE, supra note 22, at 769 ("[T]he date on which coverage under a life insurance contract becomes effective ... is usually referred to as the effective date of the policy. It may or may not be the same date as that on the face of the policy...."); JOHN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE, vol. 1, section 131 (1981) ("It is usually held that when application is made for a policy of insurance, and the application is acted upon and the contract issued, the act of delivery completes the transaction so as to place into force and effect a binding contract.").

[28] *See* ANDERSON, *supra* note 27, at section 9.3, 286 n.1 ("[o]ften there is a delay of several weeks in delivering the policy and collecting the first premium").

[29] STAFF OF THE J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 655 (Comm. Print 1984) (the "DEFRA Bluebook").

[30] *Id*., at 655, n. 57.

[31] If the "issue date" precedes the "effective date" of coverage (and no temporary coverage applies), a related question raised is whether guideline premiums or net single premiums can then apply. To avoid this question, an insurer could simply use the effective date of coverage as the date as of which calculations are made. However, since the initial premium may have been paid earlier (e.g., on the issue date or the date of application), further questions regard when such premium should be viewed as having been paid under a life insurance policy and as increasing "premiums paid" under section 7702(f)(1). If any interest or other earnings accrue on the initial premium prior to the effective date of coverage, can such amounts be viewed as gain under a life insurance policy that is entitled to tax deferral under section 72(e)? If not, does this mean that such interest/earnings must be included in the calculation of "premiums paid" when later applied to the policy? No guidance specifically addresses these questions, although it would seem from a practical standpoint that some flexibility should be allowed to insurers and policy owners. Also, for backdating to "save age," see *infra* note 63.

[32] S. PRT. NO. 98-169, VOL. I, at 579 (1984) (the "DEFRA Senate Report"). The conference report for DEFRA states that, "[w]ith respect to the effective date, the conference agreement follows the Senate amendment, adopting a general effective date that makes the new definitional provisions applicable to contracts issued after December 31, 1984...." H.R. REP. NO. 98-861, at 1076 (1984) (Conf. Rep.).

[33] DEFRA Bluebook at 656. We note that Congress followed a different approach with respect to the effective date of section 7702A, discussed *infra*, in that some changes may cause a contract to become subject to section 7702A even if the changes are made pursuant to an option under the terms of the contract.

[34] *See, e.g.*, Alfaro v. Comm'r, 349 F.3d 225, 230 (5th Cir. 2003), reh'g den., 2004 U.S. App. LEXIS 2519 (5th Cir. 2004) (stating: "As the Eleventh Circuit said in Estate of Wallace v. Commissioner …the Blue Book provides 'a valuable aid to understanding the statute.' The Commissioner properly reminds us that, in the absence of definitive legislative history—as is the situation here—substantial weight should be given to the Blue Book. Importantly, the Regulation tracks the Blue Book, and must be sustained if it is 'based on a permissible construction of the statute'"); Robinson v. Comm'r, 119 T.C. 44 (2002) (according some deference to the Bluebook explanation of the TRA); Redlark v. Comm'r, 106 T.C. 31, 45-46 (1996) (stating that "[w]here there is no corroboration in the actual legislative history, we shall not hesitate to disregard [the Bluebook] as far as congressional intent is concerned"). *See also* Travis M. Seegmiller, Note, *The New Gray Area for the "Blue Book" after Robinson v. Commissioner: Twelve Factors to Keep in Mind When Using the Blue Book as a Tool of Statutory Interpretation. (Robinson v. Commissioner, 119 T.C. 44*, 2002), 57 TAX LAW. 833-844 (2004).

[35] In section 5.01 of Notice 2006-95, 2006-2 C.B. 848 (discussed in more detail *infra*), the IRS referenced the material change standard which would apply for purposes of the Section 7702 Effective Date Rule and applied that standard for purposes of the safe harbors provided by the Notice. This seemingly would encompass the DEFRA Option Rule, although the DEFRA Bluebook was not specifically cited. Also, section 5.02 of this Notice set forth an alternative material change rule for this purpose which in some ways mirrored the DEFRA Option Rule. Further, section 5.03 of this Notice offered examples of the application of Notice section 5.02, including: "an increase or decrease in death benefit (whether or not the change is underwritten)." In contrast, the IRS previously had viewed changes that were permitted under a contract only with underwriting as not having been made pursuant to a contractual right. *See, e.g.*, Notice 2004-61, 2004-2 C.B. 596.

[36] This principle under state contract law is known as the parol evidence rule. *See* RESTATEMENT 2D OF CONTRACTS § 213 (1981); U.C.C. § 2-202 (2003); COUCH ON INSURANCE § 253:46 (2011); JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS, 3rd ed., § 4.02, 4-9 (2006).

[37] RESTATEMENT 2D OF CONTRACTS § 216 (1981) provides that extrinsic evidence of a consistent additional term is admissible to supplement an agreement if such term in the circumstances might naturally be omitted from the writing. Also, U.C.C. § 1.303 (2003) defines "course of performance" as "a sequence of conduct between the parties to a particular transaction [where] the agreement … involves repeated occasions for performance by a party[, and] the other party, with knowledge of the nature of the performance and opportunity for objection to it, accepts the performance or acquiesces in it without objection; "course of dealing" as "a sequence of conduct concerning previous transactions between the parties to a particular transaction that is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct"; and "usage of trade" as "any practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question…." In regard to these forms of extrinsic evidence, U.C.C. § 1.303(d) (2003) states that "[a] course of performance or course of dealing between the parties or usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware is relevant in ascertaining the meaning of the parties' agreement, may give particular meaning to specific terms of the agreement, and may supplement or qualify the terms of the agreement." *See also* Juliet P. Kostritsky, *Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem, 39* CONN. L. REV., VOL. 2, 451 (2006).

[38] *See, e.g.*, N.Y. INS. LAW § 4224(a)(1), providing that "[n]o life insurance company doing business in [New York] …shall … make or permit any unfair discrimination between individuals of the same class and of equal expectation of life, in the amount or payment or return of premiums, or rates charged for policies of life insurance or annuity contracts, or in the dividends or other benefits payable thereon, or in any of the terms and conditions thereof." *See also* Op. N.Y. Ins. Dept. (Dec. 13, 2000) (available online at http://www.dfs.ny.gov/insurance/ogco2000/rg001210.htm) (regarding circumstances where different rates can be used consistently with N.Y. INS. LAW § 4224(a)(1)).

[39] Section 7702(f)(7)(A) states: "If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section." Similarly, section 101(f)(2)(E) states: "The guideline single premium and guideline level premium shall be adjusted in the event of a change in the future benefits or any qualified additional benefit under the contract which was not reflected in any guideline single premiums or guideline level premium previously determined."

[40] *See, e.g.*, Fourco Glass Co. v. Transmirra Products Corp., 353 U.S. 222, 228 (1957) (citations omitted) ("However inclusive may be the general language of a statute, it will not be held to apply to a matter specifically dealt with in another part of the same enactment."); CRS Report for Congress: *Statutory Interpretation: General Principles and Recent Trends*, at CRS-10 (March 30, 2006).

[41] This statutory construction argument is strongest for policies already subject to section 7702, since it is necessary to reconcile how two provisions of the same statutory enactment interact with one another. However, given that the DEFRA Bluebook discussion of material changes is perhaps best viewed as reflecting existing law regarding material changes (that pre-dates section 101(f)), the section 101(f) adjustment rule seemingly still should be considered as a specific statutory rule intended to address changes that usually should control over general material change principles of the tax law, so that policies could continue to be subject to section 101(f) after a change.

[42] *Compare* TAM 9347005, supra note 5, in which the IRS concluded that an update program for life insurance policies that increased their permanent interest rate guarantee resulted in an exchange. *See also* the discussion of this TAM *infra* note 47.

[43] Adjustments under sections 101(f)(2)(E) and 7702(f)(7)(A) are implemented by use of the so-called attained-age increment and decrement method, which is described in the legislative history of these provisions. See STAFF OF THE J. COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY

ACT OF 1982, at 370-374 (1982); DEFRA Bluebook, at 653-54; STAFF OF THE J. COMM. ON TAX'N, 99TH CONG., 2D SESS., EXPLANATION OF TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984 AND OTHER RECENT TAX LEGISLATION 106-108 (1987). *See also supra* note 18.

[44] The DEFRA Bluebook appears to reflect a similar concern when, in discussing the section 7702(f)(7)(A) adjustment rule, it states that "Likewise, no adjustment shall be made if the change occurs automatically, for example, a change due to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or *changes initiated by the company.*" (Emphasis added.) There apparently was concern that changes that could unilaterally be made by an insurer could be used to increase guideline premiums based on the higher attained age of the insured at the time of the change. A deemed exchange of the policy would present the same concern, but generally to a greater degree than under the attained-age increment and decrement method.

[45] Aug. 17, 2007. As noted, *supra* note 3, this CCA was the subject of the article, *On Grandfathers and Adjustments: New IRS Chief Counsel Advice Memo Blurs Lines*, TAXING TIMES, May 2008, at 8. QABs are defined in section 7702(f)(5).

[46] Other policies were issued after Dec. 31, 1984, but before Oct. 21, 1988, and, accordingly, were subject to section 7702 but not to TAMRA's reasonable mortality charge rule. Material change issues involved with respect to the effective date of this rule are discussed below.

[47] *See also* Rev. Rul. 90-109, *supra* note 5 (discussed next below in connection with fundamental changes); TAM 9347005, *supra* note 5, in which the IRS concluded that an update program which changed the permanent interest rate guarantees under life insurance policies resulted in an exchange. The TAM was focused on the treatment of the policies for purposes of Subchapter L (and specifically section 811), although its conclusion that the change gave rise to an exchange was not so limited. It is unclear from the TAM whether any of the policies were originally issued after the effective date of section 7702. (Neither section 7702 nor section 101(f) is mentioned in the TAM.)

[48] *See* U.S. v. Nat'l Bank of Commerce, 472 U.S. 713 (1985) ("In applying the Internal Revenue Code, state law controls in determining the nature of the legal interest which the taxpayer has in property…. The question whether a state-law right constitutes 'property' or 'right to property' for federal tax-collection purposes is a matter of federal law."). *See also* Aquilino v. United States, 363 U.S. 509 (1960) and Morgan v. Commissioner, 309 U.S. 78 (1940) (both similar).

[49] Section 7702(a)(1).

[50] See *supra* note 48.

[51] When a policy is newly issued, guideline premiums are calculated based on the then attained age of the insured. In contrast, under the so-called attained-age increment and decrement method as described by the legislative history of section 7702(f)(7)(A), changes generally reflect the attained age of the insured only in respect of the changed portion of a policy. *See supra* notes 18 and 43 for more information regarding the adjustment rule. No guidance specifically describes how the adjustment rule might be applied upon a change of insured; because of the admittedly substantial nature of the change, it may be that use of entirely new attained-age guideline premiums represent the "proper adjustment[]" within the meaning of section 7702(f)(7)(A). Even if that were the case (which remains a mystery), this does not necessarily mean that a policy should be viewed as newly "issued" or "entered into" so that it becomes subject to different rules under section 7702 than applied when the policy was originally "issued" or "entered into," especially since the DEFRA Option Rule often would dictate the opposite result (at least with respect to the "issue date" of a policy).

[52] T.D. 8675, 61 FR 32926, 32927 (June 26, 1996).

[53] *See, e.g.*, FSA 199910009 (Dec. 2, 1996) (addressing whether a change to debt resulted in a disposition under section 1001 and stating: "Because debt principal is a fundamental element to debt, any change in the principal will be material"); CCA 200515019 (Dec. 3, 2004) (addressing the exchange of certain trading rights, citing to Rev. Rul. 90-109, but ultimately concluding that there was not a "sufficiently fundamental or material change" and that the transaction did not constitute a disposition of property for purposes of section 1001). *See also* TAM 9347005, discussed *supra* note 5 (treating the addition of an endorsement to certain life insurance policies that changed their interest rate guarantee as resulting in a section 1035 exchange).

[54] DEFRA Bluebook, at 646, n. 50.

[55] TAMRA section 5011(d) (emphasis added).

[56] TAMRA section 5012(e)(1) (emphasis added).

[57] *See, e.g.*, Perrin v. United States, 444 U.S. 37, 42 (1979); Crane v. Commissioner, 331 U.S. 1, 6 (1946) ("[T]he words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses."); Old Colony Railroad Co. v. Commissioner, 284 U.S. 552, 560 (1932); Halpern v. Commissioner, 96 T.C. 895, 899 (1991) ("It is a well-established rule of statutory construction that statutes are to be construed so as to give effect to their plain and ordinary meaning unless to do so would produce absurd or futile results."). *See also supra* note 20.

[58] The term "contract" is defined by section 1 of the first and second RESTATEMENTS OF CONTRACTS as follows: "[a] contract is a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." *See also* CORBIN ON CONTRACTS, section 1.3 (2011 Supp.). With respect to when an insurance contract comes into being, COUCH ON INSURANCE observes that:

> In order for the arrangement that is characterized as "insurance" to come into being, there must be a binding contract between the parties. The necessary elements of a binding contract of insurance are offer and acceptance, competent parties, a subject matter, a premium, an insurable interest, certain risks or perils, a duration for the risk, and a designation of the amount of the insurance. There must be a clear mutuality of consent to all of the essential terms, as well as defined limits of those terms for the formation of a valid contract.
>
> COUCH ON INSURANCE 3d § 17:1 (2011).

[59] BLACK'S LAW DICTIONARY, 9th ed. 611 (2009).

[60] Webster's Third New International Dictionary, Unabridged 757 (1986).

[61] Notice 89-15, Q&A 12. See also Treas. Reg. section 1.864-5(b)(ii) (for effective date purposes, a contract is entered into when a "binding agreement" arises); Treas. Reg. section 1.924(a)-1T(b) ("contract entered into" means "[a]ny agreement, oral or written, which constitutes a contract at law"); Treas. Reg. section 1.993-1(b) (same).

[62] H.R. REP. NO. 100-795, at 482 (1988) (the "TAMRA House Report").

[63] *Id.* In regard to backdating, professors Kenneth Black and Harold Skipper have observed that: "A policy may be backdated to 'save age.' Backdating is the practice by which an insurer calculates premiums under the policy based on an earlier age for the proposed insured. Premiums are thereby lower than they otherwise would be. Backdating beyond six months is sometimes prohibited by law." KENNETH BLACK, JR. AND HAROLD D. SKIPPER, JR., LIFE & HEALTH INSURANCE 195 (13th ed. 2000) ("BLACK & SKIPPER"). *See also* James M. Carson and Krzysztof Ostaszewski, The Actuarial Value of Life Insurance Backdating, J. OF ACTUARIAL PRACTICE, VOL 11, AT 63 (2004). While backdating generally serves a purpose wholly unrelated to tax considerations, Congress clearly had concern about use of the practice to avoid TAMRA's requirements.

[64] H.R. 4333, 100th CONG. (reported July 26, 1988).

[65] *See also* H.R. REP. NO. 100-795, at 545-46 (1988) (describing this proposed rule).

[66] H.R. REP. NO. 100-1104, vol. 1, at 108 (Conf. Rep.) (1988) (the "TAMRA Conference Report").

[67] As the Supreme Court has stated, "[w]here Congress includes limiting language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation was not intended." Russello v. United States, 464 U.S. at 23-24 (1983).

[68] TAMRA section 5012(e)(2). This rule as originally enacted was subsequently amended to read as quoted above by section 7815(a)(2) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 ("OBRA").

[69] Certainly this is the case in the context of life insurance. For example, it clearly would be improper to restart an incontestability period merely due to an amendment being made to the policy.

[70] It is a long-established principle of statutory interpretation that when Congress includes special rules in one part of a statute but omits them from another, it must be presumed to have done so intentionally. *See* Russello v. United States, 464 U.S. 16, 23 (1983), quoting United States v. Wong Kim Bo, 472 F.2d 720, 722 (5th Cir. 1972) ("Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress

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END NOTES CONT.

acts intentionally and purposely in the disparate inclusion and exclusion."). *See also* City of Chicago v. Environmental Defense Fund, 511 U.S. 328, 338 (1994); Keene Corporation v. United States, 508 U.S. 200, 208 (1993); United States v. Naftalin, 441 U.S. 768, 773-74 (1979); United States v. Wooten, 688 F.2d 941, 950 (4th Cir. 1982).

[71] For a discussion of the history relating to the enactment of section 7702A and the Reasonable Charge Rules, see John T. Adney and Mark E. Griffin, *The Great Single Premium Life Insurance Controversy: Past and Prologue—Parts 1-3*, J. OF AM. SOC'Y CLU & CHFC (May, July and September 1989).

[72] 1958 CSO contracts may be "frozen" to an even greater extent if they were issued on or after Oct. 21, 1988, and on or before Dec. 31, 1988. In Notice 88-128, 1988-2 C.B. 540, the IRS provided an interim safe harbor for satisfying TAMRA's newly enacted reasonable mortality charge requirement, stating:

> Under the second interim safe harbor, a mortality charge meets the requirements of section 7702(c)(3)(B)(i) if it does not exceed 100 percent of the applicable mortality charge set forth in the 1958 C.S.O. tables. This second interim safe harbor applies only to a contract that is not a modified endowment contract within the meaning of section 7702A of the Code, that is issued on or before December 31, 1988, and that is issued pursuant to a plan of insurance or policy blank which is based on the 1958 C.S.O. tables and which was approved by the appropriate state regulatory authority on or before October 21, 1988.

Where this rule is being utilized, a contract might comply with section 7702 based on use of 1958 CSO mortality, but if the contract later becomes a MEC (potentially many years after issue), then seemingly use of 1980 CSO mortality would be necessary. It's unclear whether retesting would be required from issuance or whether this would be treated as an adjustment event. It's also unclear whether the non-MEC condition for this safe harbor should be read in some limited manner, *e.g.*, perhaps as being relevant only during the initial 7-pay period. Despite these uncertainties, it seems clear that failure under the 7-pay test can have an effect akin to a material change, in that the failure can result in the need to use 1980 CSO or a later table rather than 1958 CSO for purposes of section 7702. For many contracts, this would result in the contracts' failure to comply with section 7702. Accordingly, where this safe harbor is being utilized, the practical consequence is that insurers need to monitor for both material changes and MEC status, and this is one instance where MEC status usually cannot be allowed even if the owner has consented to such status. The rigidity necessarily, and seemingly unintentionally, imposed on such contracts is perhaps reminiscent of the shackles which held fast poor Fortunato in Poe's *The Cask of Amontillado*; the further question here and more generally for material changes, however, is whether the IRS will offer help and flexibility, or will they stand ready with bricks and mortar in hand.

[73] *See supra* note 66.

[74] In addition to viewing the adjustment rule as taking precedence, it is also necessary to construe the material change rules of Notice 2006-95 as applying in a limited manner (*i.e.*, for purposes of the Notice's safe harbors) rather than as generally dictating when a policy would be newly issued. This point is discussed further below.

[75] Neither temporary nor final regulations have been issued with respect to the Reasonable Mortality Rule.

[76] A change to a policy already subject to the reasonable expense charge rule of section 7702(c)(3)(B)(ii) may in some instances give rise to an adjustment event under section 7702(f)(7)(A). Unlike the Reasonable Mortality Rule, the reasonable expense charge rule is not based on the issue date of a policy, and thus the discussion herein regarding when changes may give rise to a deemed new issuance is not directly pertinent. There is, however, a question regarding the circumstances in which it would be necessary to process an adjustment event with respect to expense charges. A change in current charges would not seem to be sufficient to justify an adjustment since the original application of the rule was based on an expectation, which necessarily recognizes that actual current charges may ultimately be different. On the other hand, if the guaranteed expenses are changed, it would seem appropriate to at that time reassess the amounts of the charges "reasonably expected to be actually paid." Less clear is whether such a reassessment is necessary upon an unrelated adjustment event.

[77] 2006-2 C.B. 848, *modifying and superseding* Notice 2004-61, 2004-2 C.B. 596, and *supplementing* Notice 88-128, 1988-2 C.B. 540.

[78] 2001 CSO became the prevailing mortality table (*i.e.*, at least 26 states had adopted it) in 2004, and thus under the transition rule of section 807(d)(5)(B) it generally would have been necessary to use 2001 CSO for policies issued on and after Jan. 1, 2008. To generally match the transition rules imposed by the states, the IRS through Notice 2006-95 permitted continued use of 1980 CSO during 2008, as long as a policy is within one of the 1980 CSO-based safe harbors set forth in the Notice. *See* section 4.01 and 4.02 of Notice 2006-95.

[79] Similarly, Notice 88-128 provided safe harbors for purposes of satisfying the Reasonable Mortality Rule and, for purposes of the notice, stated that:

> [W]hether a contract was issued on or before a particular date generally is to be determined according to the standards that applied for purposes of the original effective date of section 7702…. Thus, contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange. For these purposes, a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, and mortality and expense charges) are the same as the terms of the contract prior to the change.

[80] As noted above, many policies (*e.g.*, universal life insurance) provide the owner with the right to increase the death benefit, subject only to the provision of evidence of underwriting. Also, even if the insured's underwriting class is different, the owner often has a right to increase benefits, although the mortality charge guarantees that apply to the increase may reflect a substandard rating and thus would be higher than those applicable to the base coverage. As is made clear by the examples in Notice section 5.03, the IRS appropriately treats underwritten increases made pursuant to the terms of a policy as not affecting the policy's "issue date." Insurers are obligated to apply reasonable underwriting practices and cannot arbitrarily deny increases in coverage where the terms of a policy grant the right to the increase subject only to the condition that evidence of underwriting be provided. While the insurer might be entitled to apply a substandard rating due to the insured's decline in health (or due to another change, such as smoking status), the insurer generally would not be able to insist upon guaranteed mortality charges for the increase that are based on a new mortality table. Because insurers have limited discretion with respect to death benefit increases made pursuant to a right set forth in a policy, it seems that such a change should not be viewed as affecting the "issue date" of the policy under either Notice section 5.01 or 5.02. *But cf.* Notice 2004-61.

[81] In some cases, of course, it may be the insurer that is exercising a right pursuant to the terms of a policy to make a change to the policy.

[82] Given the IRS's focus on changes made pursuant to contractual rights, it appears that the IRS generally follows the former view, where Notice section 5.02 is operative and the examples listed in Notice section 5.03 only will apply if the requirements of Notice section 5.02 are met.

[83] *See supra* notes 37 and 38 and the accompanying discussion.

[84] It would seem improper, for example, to permit a bilateral change that was not made pursuant to the terms of a policy to enable the use of a full new, attained-age guideline single premium at the time of the change. As discussed above, such a result would not be proper as a matter of statutory construction, nor could it be reconciled with the applicable legislative history.

[85] Section 7702A(c)(2)(B) augments this rule by providing that: "Any reduction in benefits attributable to the nonpayment of premiums due under the contract shall not be taken into account under [section 7702A(c)(2)(A)] if the benefits are reinstated within 90 days after the reduction in such benefits." Also, section 7702A(c)(6) prescribes a similar reduction in benefits rule for second-to-die policies that applies to reductions at any time during the life of a policy.

[86] *See* TAMRA Conference Report, at 101. The preference for the reduction in benefits rule reflects the anti-abuse purpose of this rule, *i.e.*, to prevent an owner during a 7-pay period from reducing benefits and thereby having a paid-up policy before the end of such period. Thus, if two transactions are made to a policy at the same time, one being a reduction in benefits and the other being a material change (*e.g.*, a reduction in the face amount of death benefit and the addition of a QAB), it would seem that the reduction transaction generally should be processed first to be consistent with this preference, with the material change transaction being processed immediately thereafter.

[87] As noted, section 7702A(c)(3)(B) provides that increases in death benefits and QABs are material changes, but section 7702A(c)(3)(B)(i) provides an exception, stating that the term "material change":

> shall not include … any increase which is attributable to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the 1st 7 contract years (determined after taking into account death benefit increases described in [section 7702(e)(2)(A) or (B)]) or to crediting of interest or other earnings (including policyholder dividends) in respect of such premiums.…

The precise manner of applying the NPT differs between contracts subject to the guideline premium test and contracts subject to the cash value accumulation test. *See* TAMRA Conference Report, at 104-105. Also, the legislative history of OBRA clarified that it was permissible to recognize a material change upon the later of (i) the benefit increase or change, and (ii) the receipt of unnecessary premiums. *See* S. PRT. 101-56, at 266 (1989); H.R. REP. 101-247, at 1438-39. Because deferral treatment under the OBRA legislative history is permissive, some insurers choose to defer material change treatment of some benefit increases or changes (such as option 2 death benefit increases) but immediately recognize others even if no unnecessary premiums have been received (*e.g.*, a face increase). *See also* PLR 201137008 (June 14, 2011) (describing the application of the NPT in the context of a policy subject to the cash value accumulation test and addressing the permissibility of reflecting reasonable expense charges in the deemed cash value calculation).

[88] We note that the manner of defining events that trigger application of the 7702A Material Change Rule does not in all respects mirror the way such events are defined for purposes of the adjustment rule. For example, for option 2 death benefit increases, in the former case such increases constitute material changes unless the NPT applies to prevent such treatment, whereas a similar result is achieved through legislative history commentary in the case of the adjustment rule. See the DEFRA Senate Report, at 577 (stating that "no adjustment shall be made if the change occurs automatically due, for example, to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or due to changes initiated by the company"). Of course, once a material change or adjustment event arises, the rules account for the changes in very different ways, *i.e.,* under section 7702A, the policy is treated as newly "entered into" with the so-called "rollover rule" being used to account for existing cash value, whereas under section 7702 the attained-age increment and decrement method generally applies for purposes of adjusting the guideline premiums. *See supra* notes 18 and 51 (regarding the adjustment rule); TAMRA Conference Report, at 105 (regarding the rollover rule). *See also* STAFF OF THE J. COMM. ON TAX'N, 107TH CONG., TECHNICAL EXPLANATION OF THE "JOB CREATION AND WORKER ASSISTANCE ACT OF 2002" at 45-46 (JCX-12-02) (Comm. Print 2002) (confirming that the TAMRA legislative history associated with the rollover rule was controlling). Where a policy is treated as newly "entered into" under section 7702A(c)(3)(A), that treatment only applies for purposes of section 7702A; thus, this rule would not operate, in and of itself, to treat a policy as newly "entered into" for purposes of any other provision.

[89] The use of overly conservative assumptions, such as ignoring QABs, has the effect of understating 7-pay premiums relative to those permissible under section 7702A(b). While often done for administrative simplicity, such an approach raises the possibility that a policy may be identified as a MEC (and tax reported as such) even though the insurer might have appropriately applied the statute to avoid such characterization. While tax penalties may apply for inaccurate tax reporting (see sections 6721 and 6722), Congress in the OBRA legislative history discussion of the NPT appears to have recognized the appropriateness of applying conservative practices in at least one instance (*i.e.*, whether to defer or immediately recognize certain material changes) and presumably did so in part in recognition of the complexity associated with the statute's requirements. *See* the discussion of the OBRA legislative history, *supra* note 87.

[90] Pub. L. No. 105-34.

[91] *See* § 1084(d)[(f)] of the 1997 Act. *See also* H.R. REP. NO. 105-220, at 588 (1997) (Conf. Rep.).

[92] Section 264(a)(4) restricts deductions for interest on borrowing with respect to life insurance contracts.

[93] Under section 264(f)(2), the portion of the taxpayer's interest expense that is allocable to "unborrowed policy cash values" is defined as an amount that bears the same ratio to such interest expense as the taxpayer's unborrowed policy cash values of life insurance, endowment and annuity contracts issued after June 8, 1997, bears to the sum of the taxpayer's unborrowed policy cash values and the average adjusted bases (within the meaning of section 1016) of the taxpayer's other assets.

[94] The Administration's Budget proposal for fiscal year 2013 would repeal the exception for officers, directors and employees, but retain it for 20 percent owners of a business that is the owner or beneficiary of the policy. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, at 54-55 (Feb. 2012).

[95] 1997 Act section 1084(d)[(f)] (emphasis added). *See also* H.R. REP. NO. 105-220 (Conf.), at 588 (1997); STAFF OF THE J. COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 276 (Comm. Print 1997). The section 264(f) transition rule further provides that "an increase in the death benefit under a policy or contract issued in connection with a lapse described in section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 shall not be treated as a new contract." 1997 Act section 1084(d)[(f)].

[96] *See also* STAFF OF THE J. COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 580 (J. Comm. Print 1987) (describing the enactment of section 264(a)(4), regarding interest deductions with respect to corporate-owned life insurance, and observing that, while an internal exchange, standing alone, would not result in a new contract for purposes of applying that provision to an existing contract, any change to the contract that is not a "minor administrative change" may result in the contract being treated as newly issued).

[97] 2008-15 I.R.B. 747.

[98] 2011-12 I.R.B. 554.

[99] *See also* PLR 200627021 (April 6, 2006) (in which the IRS concluded that, upon an exchange of policies, section 264(f) should apply anew to the policy received in the exchange, even if the exchange qualified for tax-free treatment under section 1035; also, because the insured was no longer an employee of the policy owner at the time of the exchange, the section 264(f)(4)(A) exception did not apply with respect to the new policy); John T. Adney and Bryan W. Keene, *IRS Ruling Confirms Exchange of COLI on Former Employees Triggers Loss of Interest Deductions,* TAXING TIMES, Sept. 2011, at 9. All of this assumes, of course, that the employer-policy owner possessed an insurable interest in the covered life after the exchange. The authors understand that such a continuation of insurable interest is permitted under the laws of three states: Delaware, Georgia and Utah.

[100] Rev. Rul. 2011-9 (citing the DEFRA Senate Report, at 579). *See also* PLR 8816015 (Jan. 11, 1988).

[101] Other authorities also address the meaning of "material changes" in related contexts. *See, e.g.*, STAFF OF THE J. COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 580 (Comm. Print 1987) (regarding the effective date rule for section 264(a)(4) and the treatment of certain policy changes for this purpose).

[102] *See* Rev. Rul. 71-309, 1971-2 C.B. 168 (holding that certain changes in the ownership of a policy did not result in a new seven-year period for testing purposes under then section 264(c)(1) (now section 264(d)(1))). *Compare, infra* note 114.

[103] *See supra* note 10.

[104] STAFF OF THE J. COMM. ON TAX'N, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on Aug. 3, 2006, at 212 (J. Comm. Print 2006) (reprinted as part of the Joint Committee's General Explanation of Tax Legislation Enacted in the 109th Congress, JCS-1-07, at 516 (2007)). In a floor debate relating to the PPA, Ways and Means Committee Chairman Bill Thomas stated that "[a] detailed, plain-English explanation [of the PPA] is available from the Joint Committee on Taxation and will be a key resource in understanding the intent underlying the bill's provisions and, therefore, obviously of the legislative intent behind the bill." 152 Cong. Rec. H6158 (daily ed. July 28, 2006) (statement of Rep. Bill Thomas). *See also* 152 Cong. Rec. S8763 (daily ed. Aug. 3, 2006) (statement of Sen. Charles Grassley) (also indicating that the Joint Committee's explanation is reflective of legislative intent).

[105] 2009-24 I.R.B. 1085.

[106] There is some uncertainty regarding what is meant by an insurer's consent for this purpose. For example, should consent encompass an insurer's right to require underwriting as a prerequisite for an increase? What about circumstances in which a premium payment increases the death benefit but the insurer has reserved the right to refuse the premium, *e.g.*, because it increases the net amount at risk? Without guidance on these questions, it seems that the insurer's waiver of these rights could be viewed as giving consent, although one can question whether this is the correct result (such as in circumstances where the insurer's discretion is limited by an ascertainable standard and that standard is met).

[107] In some cases an argument might be made that the notice provided and consent obtained when the policy was originally issued satisfies the new notice and consent requirement of section 101(j) upon the material change. However, it is unclear whether such a prior notice and consent would be considered stale and thus inoperative.

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END NOTES CONT.

In this regard, Notice 2009-48 provides a one-year period for consent to coverage to remain effective. Also, because it is necessary to provide notice of the maximum face amount for which the employee could be insured, the prior notice will be inadequate where the face amount has been increased above the maximum identified in the prior notice.

[108] *See* section 848(d).

[109] Treas. Reg. section 1.848-2(c)(2) (emphasis added).

[110] Treas. Reg. section 1.848-2(c)(3)(C) (emphasis added). For purposes of applying this rule, Treas. Reg. section 1.848-2(c)(1) clarifies that an "exchange" includes a change in the terms of a specified insurance contract.

[111] A change in a temporary guarantee with respect to the amounts to be credited as interest to the policy owner's account, or charged as mortality, morbidity or expense charges, is not treated as changing the interest, mortality, morbidity or expense guarantees with respect to the nonforfeiture benefits provided in the contract if the new guarantee applies for a period of 10 years or less. Treas. Reg. section 1.848-2(c)(3)(ii)(A).

[112] Generally, nonforfeiture benefits refer to the cash value of a life insurance contract that an insurer must return to the policy owner upon surrender of the contract, together with other benefits (such as paid insurance) based on that cash value. *See* BLACK & SKIPPER, *supra* note 63, at 757.

[113] *See supra* note 88.

[114] *Compare* Cottage Savings, *supra* note 4 (where a change of obligor of mortgage obligations was held to constitute a material change in the legal entitlements under those obligations). *See also* the discussion of Temp. Treas. Reg. section 1.1001-4T(a) regarding the treatment of certain transfers or assignments of derivative contracts to the nonassigning counterparty, *supra,* note 5.

[115] PLRs 9034022 (May 23, 1990), 9034021 (May 23, 1990), 9034018 (May 23, 1990), 9034016 (May 23, 1990), 9034015 (May 23, 1990), 9034014 (May 23, 1990) and 8645008 (Aug. 4, 1986). *See also* PLR 200446001 (July 13, 2004) on the difference between assumption reinsurance and an exchange of policies.

[116] PLR 9034022 (May 23, 1990).

[117] PLR 200303028 (Oct. 2, 2002).

[118] *See, e.g.*, Rev. Rul. 2003-19 (Jan. 22, 2003); PLR 199916023 (Jan. 21, 1999).

[119] 1992-2 C.B. 410.

[120] The modification or restructuring must occur as an integral part of the rehabilitation, conservatorship, or similar state proceeding and must be approved by the state court, the state insurance commissioner, or any other responsible state official with authority to act in such circumstances. The following private letter rulings apply the relief provided in Rev. Proc. 92-57: PLRs 200814005 (Dec. 27, 2007), 200249013 (Sept. 12, 2002), 199908013 (Nov. 23, 1998), 199908016 (Nov. 23, 1998), 199912022 (Dec. 22, 1998), 9720038 (Feb. 13, 1997), 9548022 (Aug. 31, 1995), 9516056 (Jan. 26, 1995), 9445013 (Aug. 9, 1994), 9430043 (May 6, 1994), 9338023 (June 24, 1993), 9338018 (June 24, 1993), 9335054 (June 9, 1993), 9312023 (Dec. 28, 1992), 9305013 (Nov. 9, 1992), and 9239026 (June 29, 1992).

[121] PLR 201045019 (Aug. 5, 2010). *See also* Kory J. Olsen, *PLR 201045019: Adding Investment Options to In-Force Contracts*, TAXING TIMES, Feb. 2011, at 30.

[122] PLR 8648018 (Aug. 27, 1986).

[123] DEFRA Senate Report, at 579; DEFRA Bluebook, at 656.

[124] PLR 9117011 (May 18, 1990). *See also* PLRs 9150045 (Sept. 17, 1991), 9203009 (Jan. 29, 1991), 9412023 (Dec. 22, 1993), 9714029 (Jan. 7, 1997), and 9737007 (June 11, 1997).

[125] PLR 9601041 (Oct. 5, 1995) ("[N]either the proposed sale of a [life insurance company's stock to another life insurance company] nor any of the section 338 elections shall have any effect on the date that any life insurance contract was issued, entered into, or purchased for purposes of sections . . . 101(f), 264, 7702 and 7702A.").

[126] *See supra* note 98 and the accompanying text.

[127] Nov. 29, 1990.

[128] PLRs 200651023 (Sept. 21, 2006) and 200652043 (Sept. 21, 2006).

[129] Congress sometimes applies new laws retroactively, however, as was done for flexible premium life insurance contracts that are subject to section 101(f). This was done with the support of the life insurance industry.

[130] *But cf.* TAM 9347005, *supra* note 5 (concluding that a section 1035 exchange occurred where policy owners accepted an offer (not provided under the pre-change policy) to add an endorsement which permanently increased the minimum interest rate guaranteed under the policy).