



Article from

Taxing Times

Month Year June 2015
Issue Number 2

THE SECOND EDITION OF *LIFE INSURANCE & MODIFIED ENDOWMENTS UNDER INTERNAL REVENUE CODE SECTIONS 7702 AND 7702A*

by John T. Adney, Brian G. King, and Craig R. Springfield

In the fall of 2002, our colleague and friend, the late Chris DesRochers, observed that the IRS had not finalized a single regulation, and had published very little other authority, to provide guidance on the tax statutes defining life insurance and modified endowment contracts, sections 7702 and 7702A of the Internal Revenue Code.¹ This was the case even though the two statutes then were, respectively, 18 and 14 years old, and section 7702's predecessor defining flexible premium life insurance contracts, section 101(f), had then been on the planet for two decades. So, Chris proposed the SOA should publish a textbook to fill in the gap, educating life insurance product designers and tax practitioners on the subject. To join in the writing, Chris recruited two actuaries, Douglas Hertz and Brian King, and one lawyer, John T. Adney, all of whom claimed to be conversant with the statutes. (The lawyer clearly was outnumbered.)

Two years later, when the first edition of *Life Insurance & Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A*—or “LIME” for short, as the textbook was nicknamed by actuarial students—first appeared in print, still no final regulation existed under the statutes, and aside from a 2003 revenue ruling intended to address the “recapture ceiling” rules² using an example that turned out to describe a MEC,³ very little authority provided guidance. True, more and more private letter rulings concerning sections 101(f) and 7702 became public, but these did not constitute authority insurers could rely on, and they mostly dealt with insurers' self-confessed failures to comply with those Code sections. And so insurers' product designers and administrators, and the tax practitioners who looked over their shoulders, began reading *LIME* for instruction and perspective, however unofficial the book was. The book also found its way to the IRS and the Treasury Department, and the IRS saw fit to cite it in a private letter ruling.

Even as the printing press produced the initial copies of *LIME* in the fall of 2004, significant change was setting in for life

product taxation. The textbook had been drafted when the 1980 CSO Tables governed product filings and “reasonable mortality” in the section 7702 and 7702A testing, and so it contained numerous illustrations based on 1980 table mortality, but the 2001 CSO Tables were rapidly becoming the new standard. In 2004, the remediation of inadvertent noncompliance with the section 7702A rules was still relatively new, and remediation of life insurance definition failures continued to labor under the yoke of a 1991 revenue ruling and the largely undefined “reasonable error” standard of the statute.⁴ By 2008, the IRS precipitated a “remediation revolution” with its publication of a series of revenue procedures intended to streamline the restoration of contracts to compliant status. The IRS also took the step of finalizing a substantive regulation under the statutes, defining what was meant by an insured's “age.” And in 2004 the insurance industry was just getting around to recognizing the potential usefulness of accelerated death benefit riders, for which Congress had cleared the path in the 1996 HIPPA legislation.⁵ Perhaps most importantly for the future of product tax compliance, while the textbook had been drafted with practitioners (seasoned or not) in mind, the SOA began using it as course material for students seeking the FSA credential.⁶

So when the supply of *LIME* books in the SOA's warehouse became small, Chris was asked to consider a revision of the text to reflect the changing circumstances, with particular focus on the needs of actuarial students. With the retirement of Doug Hertz, Chris turned to the three co-authors of this article to join him in producing *Life Insurance & Modified Endowments 2nd Edition*, which we naturally call *LIME 2*. Not long after preparation for the new edition began under Chris's guidance in 2013, tragedy struck with his sudden and untimely death. But in the fall of that year, the three of us resolved to push forward with production of a greatly revised text, not least as a means of honoring Chris's memory. Fittingly, his name remains on the second edition, as the lead author, since it was all his idea in the first place. Chris in fact



CONTINUED ON PAGE 40

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

Brian G. King is an executive director at Ernst & Young LLP and may be reached at brian.king3@ey.com.

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

laid the groundwork for the book's new structure and its newly formed initial chapters before his passing.

LIME 2, when it is published this fall, will therefore have a new look as well as fully updated content. The second edition will begin with two chapters that provide a relatively succinct summary of all of the section 7702 and 7702A rules (and some section 101(f) rules) that actuarial students, and perhaps other students, need to know about the statutes. In doing so, Chapters 1 and 2 provide basic instruction on the calculations under the cash value accumulation test (CVAT) and guideline premium test (GPT) as well as the 7-pay test; guidance on identification of the interest, mortality, and expense assumptions to be employed in the calculations; insight into the meaning of the "applicable law" rule that first greets the reader of section 7702; a summary of other life insurance tax rules; and some useful background on how the statutes came to be. Also, Chapter 2 (like its later counterparts) provides numerous illustrations based on the 2001 CSO Tables and discusses in detail the IRS's guidance on the reasonable mortality rules. The initial two chapters, then, serve as a fairly comprehensive tour of the statutes for novitiates, albeit omitting (perhaps mercifully) the details of the adjustment, material change, necessary premium, and remediation rules.

The third chapter fills in other fundamental information that is more of interest to practitioners, such as the evolving definition of "cash surrender value" under section 7702, the (sole) regulation's direction on determining an insured's age, the limitations imposed and opportunities presented by the primary and alternate computational rules, considerations in performing post-age-100 and substandard mortality calculations, and the rules for reflecting "qualified additional benefits" (QAB) in the statutory premium limits. Chapter 3 thus details the history of the IRS's ruling position on the meaning of cash value under the life insurance definition, followed by an exploration of the rules and scope of the regulation defining age. It then proceeds to unpack the computational rules and differentiate the ways they apply under the two tests of section 7702 and under the MEC definition. The chapter concludes with a discussion of the QAB rules and the treatment of additional term insurance covering the primary life insured under a contract.

The mysteries of the so-called adjustment rules of the statutes, and the even greater mysteries of the Code's general material

change rules as they may apply to life insurance contracts, are the subjects, respectively, of Chapters 4 and 5 of *LIME 2*. Chapter 4 describes the manner in which the section 7702(f)(7)(A) adjustment provisions apply under the CVAT and apply differently under the GPT, and it also lays out the reduction-in-benefit and material change rules of section 7702A(c)(2) and (3), providing updated illustrations of their application. New in this chapter is an expanded discussion of the "necessary premium test" embedded in section 7702A(c)(3), a challenging concept that has been the focus of insurers' programming efforts in recent years. Chapter 5 undertakes a highly detailed treatment of material changes in the broad sense of the tax law, examining a set of authorities that, where applicable, can significantly disrupt insurers' efforts to comply with the statutory limitations by forfeiting "grandfathering" of pre-existing rules.

Chapter 6 in the original version of *LIME* addressed the manner in which sections 7702 and 7702A apply to special products and special features of products, and Chapter 6 of the second edition continues and elaborates on these topics. New in this chapter are discussions of guaranteed minimum withdrawal benefits under variable contracts, equity-indexed contracts, and no-lapse guarantees, along with enhanced discussion of cash value bonuses, return-of-premium benefits, and pre-need contracts.

A completely new chapter, Chapter 7, is included in *LIME 2* to provide a robust treatment of accelerated death benefits, covering qualified long-term care insurance riders subject to the section 7702B rules and chronic and terminal illness riders governed by section 101(g). This is followed by the completely revamped chapter on the remediation of contracts that do not comply with the definitional limitations, Chapter 8. The series of revenue procedures that the IRS issued in 2008 are described and discussed in detail in this chapter. The new book's two concluding chapters carry forward, with updating, the messages of the original book's final chapters. Chapter 9 reviews the history of the development of the definition of life insurance under the federal tax law as well as the events leading to the enactment of the MEC rules, and Chapter 10 considers the federal tax policy premises and implications for the definitional statutes.

LIME 2 retains the valuable appendix matter of the original text, providing reprints of the statutes themselves

(expanded to cover accelerated death benefits) and the important legislative history materials that have been key to the IRS's interpretation and the industry's understanding of sections 7702 and 7702A. Also retained and expanded is the book's glossary of terms.

The co-authors of *LIME 2* would be remiss in not mentioning the support they have enjoyed in their re-write of the book from SOA staff, experienced individuals in the insurance industry who served as peer reviewers, and their own professional colleagues (not to mention some very tolerant family members). Acknowledgement of those providing such support, naming names, will appear at the front of the new text. We look forward to seeing the second edition in print, and we hope it will serve the interests of its readers for years to come. ◀

END NOTES

- ¹ References to section are to sections of the Internal Revenue Code of 1986, as amended (Code).
- ² The ruling was Rev. Rul. 2003-95, 2003-2 C.B. 358, relating to the rules of IRC § 7702(f)(7)(B)-(E).
- ³ That is, a modified endowment contract within the meaning of IRC § 7702A(a).
- ⁴ Rev. Rul. 91-17, 1990-1 C.B. 190; IRC §§ 101(f)(3)(H) and 7702(f)(8) (providing for waiver of noncompliance in the case of reasonable error).
- ⁵ The Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, added to the Code IRC §§ 101(g) and 7702B.
- ⁶ So far, law students have not needed to master the statutes to satisfy bar examiners, and those seeking the CPA designation appear equally safe.

SOCIETY OF ACTUARIES

SOA EXPLORER TOOL

Find fellow actuaries around the block or around the globe

The newly-created SOA Explorer Tool is a global map showing you where SOA members, their employers and actuarial universities are located.

To use the SOA Explorer Tool, visit soa.org and sign in as a member.

