Article from

Taxing Times

October 2015
Issue 3

In the Beginning … A Column Devoted to Tax Basics

Qualification of Life Insurance Contracts under the Internal Revenue Code

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Qualifying a life insurance contract under the federal tax law requirements seems like a relatively straightforward exercise … right? Simply limit the premiums and/or cash values to satisfy the section 7702 requirements and make sure you identify whether a contract satisfies the 7-pay test of section 7702A, and you're all set. If it were only that simple! Those who have responsibility for designing and administering life insurance contracts to conform to the section 7702 and 7702A requirements know the devil is in the details.

This edition of the "In the Beginning…" column presents the basic actuarial requirements imposed by the Internal Revenue Code on life insurance contracts, focusing on the four actuarial tests in sections 7702 and 7702A. Yes, there are four actuarial tests. While most generally think of the "Big 3"—the guideline premium test (GPT), the cash value accumulation test (CVAT) and the 7-pay test—there is a fourth test lurking inside section 7702A, the so-called necessary premium test (NPT). What follows is a presentation of the basic rules underlying each of the actuarial tests and some more detailed thoughts on this fourth test, which is one of the more mysterious aspects of dealing with contractual changes under these statutes. The column does not endeavor to answer the many questions that arise with implementing any of the qualification tests, but instead attempts to set forth the general concepts underlying them. It will not look to cite the legislative history, delve into the nuances or technical aspects of defining the actuarial limitations, or attempt to set forth details on precisely how the actuarial tests should be applied. This being said, we hope that this column's discussion of the tests, and particularly the concepts underlying the NPT, will be helpful as further technical questions arise. With respect to the NPT, the thoughts expressed herein are based on our own interpretations of that test and in part on our experiences and understanding of how insurance companies have implemented it.

SECTION 7702 AND 7702A QUALIFICATION REQUIREMENTS

Life insurance provides a number of benefits to its policyholders under the federal income tax, including the tax-free receipt of death benefits. In addition, absent a distribution while the insured is alive, the increments in the cash surrender value of permanent life insurance contracts—such as whole life, universal life, variable life and some level premium term life insurance—due to the crediting of interest, earnings and policyholder dividends generally are not currently includible in the gross income of policyholders for federal tax purposes (the so-called "inside buildup"). Further, the manner in which income is taxed upon distributions (including loans) of cash value to policyholders will depend on whether the contract is characterized as a "modified endowment contract" or MEC. Today, Internal Revenue Code sections 7702 and 7702A define the actuarially based limitations that, if complied with, serve as the gateway for a life insurance contract to receive the tax treatment just referenced.

Life insurance companies and administrators of life insurance contracts are charged with the responsibility of developing and administering their contracts within requirements imposed by section 7702 and with properly identifying whether contracts constitute MECs, which are defined by section 7702A. This involves, among other requirements, the determination of actuarial funding limitations and the monitoring of funding levels (e.g., premiums paid and/or cash surrender values) to ensure that contracts are administered within actuarial limits. Both sections 7702 and 7702A impose bright-line tests for establishing compliance, and the consequences of being on the wrong side of the line can be significant, jeopardizing the tax treatment of the life insurance contract that is expected by policyholders.

TAX DEFINITION OF A LIFE INSURANCE CONTRACT

Section 7702 provides a statutory definition that a contract must meet to be treated as a life insurance contract for federal tax purposes. To qualify under section 7702, a contract must satisfy either of two alternative actuarial tests that are designed to limit investment orientation: (1) the cash value accumulation test (CVAT) or (2) the guideline premium test (GPT). Each actuarial test is designed to limit the allowable premium and/or cash value for a given death benefit in order for the contract to be respected as life insurance for federal tax purposes.

Cash value accumulation test: The CVAT regulates the relationship between a contract's cash value and its death benefit (and certain other benefits or riders). Provided the cash value does not exceed a net single premium required to fund the future benefits provided under the contract, the contract will generally satisfy the requirements of the CVAT. The CVAT commonly applies to traditional fixed premium

contracts, although it can also apply to flexible premium contracts such as universal or variable universal life insurance.

Guideline premium test: The alternative to the CVAT is the GPT, which almost exclusively applies to flexible premium contracts. The GPT is a dual-element test that is met if (1) the total of the gross premiums paid under the contract does not exceed the guideline premium limitation and (2) the death benefit is at least as great as a specified percentage of the contract's cash value (sometimes referred to as the cash value corridor requirement). The guideline premium limitation at any time equals the greater of the guideline single premium (GSP) or the sum of the guideline level premiums (GLPs) to that time. The cash value corridor requirement is similar in concept to the CVAT requirement, providing for a maximum permissible cash value for a given death benefit. Under the GPT however, the maximum permissible cash value is generally greater than what is provided for by the CVAT, in part because of the funding limitation the GPT imposes on the allowable premium.

MODIFIED ENDOWMENTS AND THE 7-PAY TEST

Section 7702A defines a class of life insurance contracts called modified endowments, or MECs. MECs are intended to represent life insurance contracts with a relatively high investment orientation. A MEC is a life insurance contract that satisfies the section 7702 requirements but fails to meet a premium-based test that is designed to measure the rate of funding of the contract, called the 7-pay test. Unlike the GPT, which applies over the life of a contract, the 7-pay test only applies for the first seven contract years, as its name would suggest (or for the seven-year period following certain contractual changes—more to come on this). MECs are accorded the same tax treatment as all other life insurance contracts, with the exception that, prior to the death of the insured, the distribution rules governing deferred annuities will generally apply. Distributions from MECs are therefore taxed on a last-in, first-out (LIFO) basis, where income is distributed first before returning a policyholder's cost basis, or investment in the contract. Further, pre-death distributions from MECs, which would also include policy loans and assignments, may also be subject to an additional 10 percent penalty tax, if, for example, the owner of the contract is younger than age 59 ½ at the time of the distribution. In contrast, pre-death distributions from a contract that is not a MEC (a non-MEC) are taxed on a first-in, first-out (FIFO) basis, meaning that the investment in the contract is viewed as returned (tax-free) to the policyholder before any income is distributed. Identifying whether a contract is a MEC is therefore of critical importance in order for an insurer to properly tax-report and withhold on pre-death distributions paid to policyholders.

CONTRACT CHANGES UNDER SECTIONS 7702 AND 7702A

Life insurance contracts are often designed with an inherent level of flexibility, allowing a policyholder to increase or decrease existing benefits, add new benefits or even adjust the insured's risk classification (e.g., changes from smoker class to nonsmoker class) relative to what applied when the contract was originally issued. Section 7702 has built-in adjustment rules that are designed to adjust the actuarial funding limitations to reflect contractual changes so as to keep the actuarial limitations in line with the changed contract and the corresponding funding needed for its revised future benefits.

Section 7702A takes a different approach in dealing with contractual changes, providing for two adjustment rules that fundamentally differ in how they apply. The first adjustment rule deals with reductions in benefits. Provided benefits are contractually reduced in the first seven years (the period over which the 7-pay test applies), the reduction in benefit rule requires a retroactive application of the original 7-pay test, but with a new 7-pay premium that is based on the reduced level of benefits. Reapplying the 7-pay test with a reduced 7-pay premium limitation can cause a contract to become a MEC due to prior premiums exceeding the revised 7-pay premium limitation based on the lower benefits. (A special, more onerous rule applies in the case of death benefit reductions under survivorship contracts.)

A second adjustment rule applies under section 7702A for contractual changes that are called "material changes." The material change rules are broadly defined in section 7702A to include any increase in benefits

<table>
<tr><th colspan="5">General Tax Treatment of a Life Insurance Contract</th></tr>
<tr><td colspan="2">Does Contract Comply with Section 7702?</td><td colspan="2">Yes</td><td>No</td></tr>
<tr><td colspan="2">MEC Status</td><td>Non-MEC</td><td>MEC</td><td>Not Applicable</td></tr>
<tr><td colspan="2">Tax Characterization of the Contract</td><td colspan="2">Life Insurance Contract</td><td>Insurance Contract</td></tr>
<tr><td colspan="2">Death Benefits Treatment</td><td>Tax Free</td><td>Tax Free</td><td>Tax Free for Net Amount at Risk Only</td></tr>
<tr><td colspan="2">Tax Treatment of "Earnings" on Cash Value</td><td colspan="2">Deferred until "Distributed"</td><td>Taxed Annually</td></tr>
<tr><td rowspan="4">Taxation of Distributions of Cash Value</td><td>Applicability of 10% Penalty Tax</td><td>Not Applicable</td><td>Yes, with Exceptions</td><td rowspan="4">Not Taxable</td></tr>
<tr><td>Partial Surrenders and Withdrawals</td><td>FIFO</td><td>LIFO</td></tr>
<tr><td>Distributed Dividends</td><td>FIFO</td><td>LIFO</td></tr>
<tr><td>Loans, Assignments and Pledges</td><td>Not Taxable</td><td>LIFO</td></tr>
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(including increases in qualified additional benefits, or QABs) and may also include other contractual changes such as a change in the underwriting status of the insured from a smoker class to a non-smoker class. When a material change occurs, section 7702A views the contract as newly entered into and requires the calculation of a new 7-pay premium and the start of a new 7-pay testing period. Unlike the reduction in benefit rule, which requires the retroactive reapplication of the 7-pay test, the material change rule starts a brand new 7-pay test period, as if the contract were newly entered into on the date of the material change.

THE SECTION 7702A MATERIAL CHANGE RULES AND THE NPT

Perhaps one of the most complex aspects of administering such changes deals with the NPT, which provides conditional relief from the section 7702A material change rules. As mentioned above, the definition of material change in section 7702A is broad, referring to *any* increase in benefits. Section 7702A, however, provides for an exception to the material change rules—specifically, the NPT—that allows certain increases in benefits to escape the material change rules if certain requirements are satisfied.

It is common practice for insurance companies to rely on the NPT to avoid material change treatment for certain increases in death benefits that occur normally under the operation of the contract, including increases in death benefits resulting from:

- The growth in cash value under an option 2 death benefit (where the death benefit equals the face amount plus the cash value)
- Increases in death benefit necessary for contracts to remain in compliance with the GPT or CVAT (commonly referred to as "corridor increases")
- Dividend purchased paid-up additions for participating whole life insurance.

For some, there may be a misconception that these types of death benefit increases are not material changes under section 7702A. Such a misconception may be based on the fact that these changes usually do not result in an adjustment to guideline premiums under the section 7702 adjustment rule, and thus one might expect similar treatment to apply in the context of section 7702A. These types of death benefit increases, however, are material changes under the general rules of section 7702A, but may escape material change treatment because of the NPT. The relief from the material change rules provided by the NPT is not automatic, however, and requires either monitoring of premium payments to ensure that premiums are "necessary" or a demonstration that only "necessary" premiums are possible based on the contract's design … more to come on what it means for a premium to be necessary. If an unnecessary premium (i.e., a premium that is not "necessary") is paid, a previous increase in death benefit or QAB that was not administered as a material change would need to be recognized as a material change at the time of that payment, resulting in the calculation of a new 7-pay premium and the start of a new 7-pay test period. Thus, the conditional relief provided by the NPT may be temporary, in that it may only defer recognition of the material change until a later unnecessary premium is paid. The remainder of this column will expand on application of the NPT, focusing on how to determine when a premium is "necessary."

The key to understanding the NPT lies with how benefits are accounted for in the application of both the 7-pay test and the test for determining whether a premium is "necessary." It involves a line drawing exercise to separate the death benefit and QABs present upon issuance of the contract (the "7-pay tested benefits") from the increased death benefits or QABs, for which recognition as a section 7702A material change has been deferred due to the NPT. The 7-pay tested benefits are the benefits present at contract issuance and taken into account in the calculation of the original (or most recent) 7-pay premium. They are the benefits that form the basis for the initial (or again, most recent) application of the section 7702A 7-pay test and are also those that form the basis of the limitation for determining whether a premium is a necessary premium. In contrast, increased death benefits or QABs for which material change treatment has been deferred because of the NPT are conceptually sitting "outside" the 7-pay test; they are not part of either the 7-pay premium limitation or the necessary premium limitation.

The NPT allows for funding that is "necessary" to support the 7-pay tested benefits, providing relief from material change treatment of increased benefits until such time that premiums "unnecessary" to support the 7-pay tested benefits are paid. The NPT looks to section 7702 for the standard to apply in identifying whether a premium is a necessary premium.

GPT Contracts: In the case of a contract that satisfies the GPT, a premium is necessary to fund the 7-pay tested benefits to the extent premiums paid do not exceed the excess, if any, of:

(1) the greater of the guideline single premium (GSP) or the sum of the guideline level premiums (GLPs) to date based on the 7-pay tested benefits, over

(2) the sum of premiums previously paid under the contract.

For a GPT contract, the standard for determining whether a premium is necessary will therefore be based on guideline premiums and premiums paid in a manner similar to the normal operation of the GPT. A couple of observations for GPT contracts:

- As noted, the GSP and GLP are based on the 7-pay tested benefits only (the "NPT GSP and GLP"), not on the actual GSP and GLP used for purposes of qualifying under section 7702 (the "Section 7702 GSP and GLP").
  - o The NPT GSP and NPT GLP are used to define

the maximum allowable funding under the NPT.

  - To the extent a benefit increase results in an adjustment to the Section 7702 GSP and GLP but is deferred from treatment as a material change due to the NPT, there will be a difference between the Section 7702 GSP and GLP and the NPT GSP and GLP.

- The cumulative premium paid represents the extent to which the contract is currently funded and is generally the same amount for both NPT and section 7702 qualification purposes.
- A premium is a necessary premium to the extent it does not cause premiums paid to exceed the guideline premium limitation based on the NPT GSP and GLP:

  Necessary Premium^{GPT} = Max[NPT GSP; Sum of NPT GLP] – Premiums Paid

CVAT Contracts: For a contract that is designed to satisfy the requirements of the CVAT, a premium is a necessary premium to the extent it does not exceed the excess, if any, of:

(1) the attained age net single premium (NSP) for the 7-pay tested benefits immediately before the premium payment, over

(2) the guaranteed cash surrender value (also referred to as the "deemed cash surrender value") of the contract immediately before the premium payment reflecting certain assumptions dictated by section 7702 (or actual cash value if less).

A couple of observations for CVAT contracts:

- The attained age NSP for the 7-pay tested benefits is used to define the maximum allowable funding under the NPT (i.e., the maximum permissible deemed cash surrender value), and, once this limit is reached, any further premium is treated as unnecessary.
- The deemed cash surrender value for the contract represents the extent to which the contract is currently funded by all premiums and how that cash value would develop based on guaranteed and certain other assumptions of section 7702.
- Unlike the CVAT, which restricts the actual or current cash value, the NPT uses a guaranteed or deemed cash value for determining whether a premium is a necessary premium.
- A premium is necessary to the extent it does not cause the deemed cash value of the contract to exceed the attained age NSP for the 7-pay tested benefits.

  Necessary Premium^{CVAT} = NSP$^{\text{7-pay Tested Benefits}}$ – Deemed Cash Value (or actual cash value, if less)

Further Thoughts on the NPT: While there are different standards used to determine whether a premium is a necessary premium based on the section 7702 qualification test selected (i.e., the GPT and the CVAT), similar principles apply to contracts under both tests. A necessary premium is a premium that is needed to fund the 7-pay tested benefits based on contractual guarantees (subject to the general limitation on actuarial assumptions imposed by section 7702). Whether a premium is needed to fund the 7-pay tested benefits is a function of the contract's current funding level relative to the amount needed to fully fund the 7-pay tested benefits based on these assumptions. Put differently, the necessary premium represents the additional funding needed to fully fund the 7-pay tested benefits:

Allowable Necessary Premium = Funding Limit for 7-Pay Tested Benefits – Current Funding for the Contract

Provided a policyholder has not fully funded the 7-pay tested benefits (i.e., all premiums are needed to fund the 7-pay tested benefits based on the methodology prescribed by the NPT), all future increases in death benefits or QABs can escape the section 7702A material change treatment until a later unnecessary premium is paid (i.e., an amount is paid that exceeds the section 7702 funding limit for the 7-pay tested benefits). Once an unnecessary premium is paid, a section 7702A material change must then be recognized where prior material change treatment of excluded benefits has been deferred, bringing the previously increased benefits into the purview of the 7-pay test and including them in the calculation of the new 7-pay premium.

CONCLUDING THOUGHTS

While the basic concepts underlying the actuarial qualification requirements of sections 7702 and 7702A may seem on the surface to be relatively straightforward, having the responsibility for product tax compliance oversight for an insurance company is not for the faint of heart. It requires effective oversight that involves wearing many different hats, including tax, actuarial, legal, policyholder administration and information technology, to name a few. Errors in the design or administration of contracts can lead to noncompliance with section 7702 or unknowing MECs that can expose insurers—and potentially their policyholders—to significant costs and liabilities. Dedicating the proper resources and establishing appropriate procedures for an effective oversight program are critical to managing and mitigating product tax compliance risk. ■

Note: The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or Davis & Harman LLP.

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