Article from

Taxing Times

October 2015
Issue 3

Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part II: Policyholder Tax Issues

By Peter Winslow (Moderator), John T. Adney, Sheryl Flum, Susan Hotine, Brian King and Mark S. Smith

Note from the Editor:
Welcome back to our series of dialogues on the important and evolving topic of the extent to which federal tax law defers to the National Association of Insurance Commissioners (NAIC) in taxing life insurance companies and products. This is the second of three parts and focuses on product taxation, including life insurance, annuities, long-term care insurance, and a related feature—accelerated death benefits (ADBs). Part I of the dialogue, in the previous issue of Taxing Times, *explored many aspects of tax reserves, including their deductibility, classification and computation. Part III of the series will be a catch-all of other life insurance tax provisions where deference to the NAIC may be relevant.*

I'd like to thank the panel of highly experienced tax professionals joining us for this discussion. Peter Winslow of Scribner, Hall & Thompson, LLP developed the concept for the dialogue and serves as moderator. Peter is joined by Mark Smith of PricewaterhouseCoopers, LLP and Sheryl Flum of KPMG LLP (both of whom have previously headed the Internal Revenue Service (IRS) Chief Counsel's Insurance Branch), along with Susan Hotine of Scribner, Hall & Thompson, LLP and John T. Adney of Davis & Harman, LLP. Susan, John and Peter were all active in the legislative process "in the beginning"—during the enactment of the Tax Reform Act of 1984. Additionally, Brian King of Ernst & Young LLP joins the panel for Part II of the series, providing an important actuarial perspective on the issues at hand.

Readers will notice that our "In the Beginning..." column in this issue also addresses the taxation of life insurance products. The column explores the conceptual and computational underpinnings of the tax law requirements, including a special discussion of the necessary premium test. This dialogue will put the topic in the context of the wider regulatory framework for insurance products in the United States. Our panel will also incorporate discussions of past and potential future guidance from Treasury and the IRS, and explore the treatment of other products in addition to life insurance. While "In the Beginning..." is targeted for our readers with less experience in the technical area addressed, we believe the dialogue will be an interesting and entertaining read for insurance professionals of all backgrounds. Enjoy!

Peter Winslow: This is the second installment of our three-part dialogue on the issue of federal tax law's deference to insurance regulation rules. This time we are shifting from tax reserves to policyholder tax issues. It seems to me that the role of state insurance regulation in the context of policyholder taxation may involve a two-part analysis. First, we need to see whether, and to what extent, the tax law defers to the NAIC or state regulators in classifying the types of contracts that are entitled to favorable (or unfavorable) policyholder tax treatment. And, second, to the extent the Internal Revenue Code imposes qualification requirements for specific tax treatment, to what extent do those tests rely on the meaning the NAIC or regulators give to the components in the tests?
John, I would like you to set the stage for us. Could you give us a short beginner's guide to the general rules of policyholder taxation for the various types of products offered by life insurance companies?

John Adney: Certainly, Peter. The products to be considered are life insurance, annuities and long-term care insurance, and a feature warranting special consideration is the acceleration of death benefits. A complete discussion of these products' federal income tax treatment in policyholders' hands would fill a couple of books, so let's boil that treatment down to its essence with the theme of this dialogue (deference to the NAIC) in mind, running the risk that the simplified explanation here will make seasoned practitioners wince at the imprecision. At this time, I will describe the tax treatment of life insurance and annuities, and will defer the discussion of long-term care insurance and ADBs until a little later.
Since the beginning of the income tax in the United States, life insurance death benefits generally have been tax-free, and the cash value build-up of permanent life insurance—sometimes called the inside build-up—is not taxed unless and until it is distributed while the insured is alive, and maybe not then. For this to be true, however, the contract must qualify as a life insurance contract for federal tax purposes under one of two actuarially based tests set forth in section 7702 of the Internal Revenue Code. Depending upon the test used, this tax definition of life insurance limits the cash value that may be available or the premiums that may be paid for a given amount of death benefit. Section 7702 applies to whole life insurance, universal life insurance, variable and indexed forms of life insurance, and even to term insurance. Also, for the death benefit to be received tax-free, it is necessary that the applicant for the coverage have an insurable interest in the insured's life under state law, and the contract must not have been transferred for valuable consideration, such as a sale of the contract in a life settlement.

CONTINUED ON PAGE 14

How and when such cash value distributions are taxed depends on whether the contract is classified as a modified endowment contract, or MEC; a MEC is a contract that is fully paid for in just a few years, as defined in tax law rules discussed later. Simplistically described, a cash distribution, as well as a loan, taken from a MEC is included in income to the extent the contract's cash value exceeds the policyholder's investment in the contract, which generally equals the premiums paid. This is sometimes called income-first treatment. It may also be subject to a 10 percent penalty tax. If the contract is not a MEC, which we artfully call a non-MEC, the rule is reversed: a cash distribution is not included in income unless it exceeds the investment in the contract, and a loan is not taxed at all unless the contract terminates before the insured dies. Finally, premiums paid for life insurance generally are not tax deductible, with exceptions where life insurance is used to provide employee benefits; interest deductions of business taxpayers that own life insurance may be limited; and if the insurance covers the life of an employee, the death benefit paid to an employer will be taxable unless the employee is in a highly compensated group and has been notified of and consented to the coverage.

Deferred annuities share some of the tax treatment of MECs. The build-up of their cash values generally is not currently taxed, but if a distribution or loan is taken before the contract is annuitized, it is taxed on an income-first basis, and a penalty tax will apply unless the contract owner is over age 59½ or some other exception to the penalty is available. On the other hand, unlike the case with life insurance, any amount paid as a death benefit under a deferred annuity is taxed to the beneficiary to the extent it exceeds the owner's investment in the contract. Once a contract is annuitized, meaning that fixed or determinable payments will be made periodically, each payment is partly includible in income and partly excludable based on a ratio described in regulations. For any of this treatment to apply, the contract must be recognized as an annuity within the customary practice of insurance companies, must provide for the systematic liquidation of its principal and interest or earnings increments, and must provide for its liquidation after the death of the owner within the time frame and manner specified in section 72(s) of the Code.

Once a contract is annuitized, meaning that fixed or determinable payments will be made periodically, each payment is partly includible in income and partly excludable based on a ratio described in regulations.

Three other comments about annuities are in order. First, for a variable annuity (or a variable life insurance) contract to receive the treatment just described, its separate account must comply with certain investment diversification requirements and its policyholder must not be viewed as controlling the separate account investments. Second, if the owner of an annuity is a corporation or other non-natural person, the inside build-up may be currently taxable. Third, payments from annuities are subject to the investment income tax (the so-called Medicare tax) that took effect in 2013.

Peter: Now that we know the general policyholder tax rules, let's start with life insurance and annuities. John, where were we on the deference issue before the 1984 Tax Act?

John: There was no comprehensive tax definition of life insurance before the 1984 Act, although section 101(f) of the Code (as enacted in 1982) provided rules for universal life insurance comparable to those in today's comprehensive definition. Instead, the governing law was case law, which looked to state law and customary practice, with the Supreme Court's caveat that insurance must involve risk shifting and risk distribution. There were no MEC rules, so the tax treatment of distributions and loans during the insured's lifetime followed the non-MEC rules I just described. While premiums paid for life insurance generally were not tax deductible, many of the restrictions on the interest deductions of business taxpayers owning life insurance had yet to be enacted, and no rules taxed the death benefit paid to an employer on an employee's life unless the employer lacked an insurable interest.

The tax treatment of annuity contract distributions was already in place for the most part before 1984, although the investment diversification rules for variable contracts were not added until the 1984 Act, and the tax treatment of corporate-owned annuities was the subject of legislation in 1986.

Peter: Susan, how did Congress deal with these issues in the 1984 Act? What role did deference to the NAIC or state regulators play?

Susan Hotine: In 1984, Congress recognized that state regulation of insurance differentiated between life insurance, endowment and annuity contracts based on the type of risk assumed for payment of benefits and set forth minimum reserve requirements for a life insurance company to ensure the company had the assets to pay the benefits. Although state regulation recognized a need for consumer protection by also requiring certain minimum cash surrender values for such contracts to provide the contract owner with some current economic value, or societal protection by requiring an insurable interest, the states did not necessarily focus on the varied reasons for purchasing

life insurance or annuity contracts. I think the development of flexible premium life insurance, which unbundled whole life insurance for the consumer, and the crediting of excess interest, which served a policy dividend purpose in the context of non-participating policies, gave legislators and their tax staff a better understanding of the fact that whole life insurance and annuities might be viewed and purchased sometimes as investments rather than merely as financial protection against early death or outliving retirement assets.

Whereas the tax benefits afforded life insurance and annuity contracts may have been grounded in the concept of providing financial protection, the tax benefits applied generally to any life insurance or annuity contracts issued, irrespective of whether the contracts carried significant insurance risk for the issuer as compared to the investment elements. So a life insurance contract was generally defined as a contract with an insurance company which depends in part on the life expectancy of the insured and which is not ordinarily payable in full during the life of the insured.[1] In 1984 (and even in 1982), Congress concluded that the tax law did not have to be restricted to what was considered to be life insurance or an annuity within the customary practice of insurance companies. So I suppose one could reasonably conclude that in 1984 Congress did not think it needed to defer to state regulation completely regarding what should be taxed as life insurance and annuity contracts.

Peter: What about the reference to "applicable law" in section 7702? Isn't that an element of deference to state regulation?

Susan: In 1984, Congress' concern was focused primarily on the investment orientation of the life insurance and annuity products being marketed by life insurance companies. Section 7702 built on the model in section 101(f) for recognizing a flexible premium life insurance contract, but provided a definition of life insurance for tax purposes that had broader application. You are right that the section 7702 definition starts with a contract that is "a life insurance contract under the applicable law," so the tax definition of life insurance starts with an explicit deference to the NAIC and state regulators as to what contracts constitute life insurance. The tax definition then requires that the contract, which otherwise would be life insurance, meet one of two tests. Both of these tests were designed to suppress the contract's investment orientation—that is, the amount of the cash surrender value in relation to the face amount or the amount at risk under the contract. Congress wanted to preserve the role of life insurance as financial protection against early death while at the same time discouraging purchasers from using it purely as an investment.[2] Note that the section 7702 definition of life insurance eliminated the typical investment-oriented endowment contract as a contract entitled to life insurance tax benefits.[3]

Peter: What about annuities? How did Congress approach those in the 1982 and 1984 reforms?

Susan: Congress wanted to preserve the use of annuity contracts for additional retirement savings while limiting their use as pure investment. The income-out-first rule, a penalty for withdrawals before age 59½ and the distribution-at-death rules, which brought annuity contracts more in line with the rules for qualified pension contracts, were all aimed at that point.

The Code does not contain a comprehensive tax definition of an annuity contract (like section 7702 does for life insurance), but section 72(s) does provide that a contract shall not be treated as an annuity contract for tax purposes unless it provides for certain required distributions if the contract holder dies before the entire interest in the contract is distributed.[4] Likewise, section 817(h) provides that, for purposes of subchapter L and section 72, a variable annuity based on a segregated asset account shall not be treated as an annuity unless the investments in the account are adequately diversified. But, as John indicated earlier, for tax treatment as an annuity to apply generally, the contract must be recognized as an annuity within the customary practice of insurance companies, and must provide for the systematic liquidation of its principal and interest or earnings increments.[5] Although the Code does not provide an explicit statutory reference, based on general rules of statutory construction, I would say that the Code gives implicit deference to the NAIC and state regulatory authorities regarding when a contract constitutes an annuity contract for tax purposes and then adds a tax twist with the distribution-at-death rules and the diversification rules for variable contracts.

Mark Smith: Susan, I agree with that, and would add there's almost nowhere else to turn as a starting point for defining an annuity contract. Section 1275(a)(1)(B) makes it clear that an insurance company subject to tax under subchapter L may issue a term annuity that is still an annuity contract for tax purposes. A bank, for example, that issues the same contract would be treated as issuing a debt instrument. So at least as a starting point, the differentiator for tax purposes almost has to be the NAIC and state regulatory rules that apply to insurance companies and define an annuity contract.

Peter: John and Susan have focused on the classification of the types of contracts that qualify as life insurance and annuities for the policyholder. Brian, let's go to the second part of the analysis—in the case of life insurance, what is the role of deference to the NAIC and state regulation in the elements of the guideline premium and cash value accumulation tests?

Brian King: As John and Susan alluded to, section 7702 imposes qualification requirements on life insurance in order for the contract to be eligible for

CONTINUED ON PAGE 16

the tax treatment provided under the Internal Revenue Code—generally the tax-free receipt of death benefits and the tax deferral of the inside build-up. For a tax qualifying life insurance contract, section 7702 requires—in addition to the applicable law requirement—that the contract satisfy one of two actuarial tests: the guideline premium and cash value corridor test (GPT) or the cash value accumulation test (CVAT). Each test works to restrict the investment orientation of a life insurance contract by limiting either the allowable premium and/or cash value for a given death benefit. The GPT largely applies in practice to flexible premium products like universal and variable universal life insurance and imposes a limitation on the cumulative premiums paid to the greater of a guideline single premium or the cumulative guideline level premium. The CVAT generally applies to fixed premium products like nonparticipating and participating whole life insurance, and limits the cash surrender value to that of a net single premium necessary to fund future benefits.

It is worth noting that section 7702 does not define an explicit funding limit under either the GPT or the CVAT. There are no prescribed tables that define a dollar amount for either guideline premiums or net single premium. Instead, section 7702 defines the allowable benefits, expenses, interest and mortality assumptions that can be used in calculating the limit and leaves it up to the actuaries to determine what they are for a particular contract. While contractual benefits and guarantees serve as the starting point for these assumptions, section 7702 also imposes limitations on what is allowed in calculating the guideline and net single premiums. For example, the guideline single premium requires the use of an interest rate that is not less than 6 percent, while the guideline level premium and net single premium require a rate not less than 4 percent. These restrictions are not intended to limit or impose constraints on contractual terms, but were instead put in place as a safeguard to control the magnitude of the actuarial limitations and to prevent potential manipulation of assumptions or benefits that may potentially overstate the limitations. That being said, there is not a direct reliance on the NAIC or state regulators in defining the section 7702 limitations nor is there a requirement by regulators that a contract qualify as life insurance for tax purposes.

That is not to say the NAIC does not play a role with how contracts qualify under section 7702. Because section 7702 defines the actuarial limitations by reference to policy guarantees, the NAIC has indirect influence on how guideline and net single premiums are calculated to the extent of their control over policy guarantees. The role of the NAIC is of particular importance in determining the mortality standards for calculating guideline and 7-pay premiums, particularly with the advent of the reasonable mortality standards introduced in 1988. For contracts issued after Oct. 20, 1988, guideline and net single premiums must be calculated using "reasonable mortality." While the statute does not provide a definition of reasonable mortality, it does provide for a limit on charges that would be considered reasonable. The limit is based on the prevailing commissioners' standard tables in effect at the time a policy is issued. Since the prevailing tables are those approved for use by the NAIC for purposes of both valuation and nonforfeiture purposes, Congress is effectively deferring to the NAIC for defining reasonable mortality under section 7702.

It is also worth noting the NAIC gave deference to the Internal Revenue Code recently with regard to setting a 4 percent floor on the Standard Nonforfeiture Law (SNFL) maximum interest rate. This change was put in place as a safeguard to ensure that minimum cash values required for state law purposes don't exceed the section 7702 net single premium under the CVAT. Since the nonforfeiture maximum interest rate is defined by a formula, it is theoretically possible the formula could produce an interest rate less than 4 percent under an extended period of low interest rates. This change was effected through amendments to the SNFL for policies issued prior to the operative date of the Valuation Manual, and to VM-02, which defines mortality and interest standards for nonforfeiture values on policies issued once the Valuation Manual becomes operative, which appears likely to occur in 2017.

Peter: That's interesting. The deference issue now seems to be a two-way street with the Internal Revenue Code sometimes deferring to NAIC standards and the NAIC sometimes deferring to the Internal Revenue Code's requirements to avoid tax problems. Is there some deference to the NAIC or state regulation in deciding what qualifies as, for example, a premium paid under the contract, or, say, the cash surrender value of the contract in applying these 7702 tests? Where do we look for defining these terms?

Brian: As I just mentioned, section 7702 defines actuarial limitations on the permissible funding for a life insurance contract in the form of guideline and net single premiums. The GPT places a limit on the premiums paid for a qualifying life insurance contract, while the CVAT limits the cash surrender value. Thus, both premiums paid and cash surrender values serve as the measuring stick for investment orientation under section 7702. These terms have very specific meaning in section 7702 and also play an important role in defining the gain or income on the contract for purposes of taxing distributions paid to policy owners under section 72(e).

What's interesting and maybe somewhat confusing to some with the section 7702 definition of premiums paid is the circular nature of its definition, which uses the term "premiums paid" to define premiums paid. While there isn't a technical definition of what constitutes premiums paid, it tends to follow what is commonly characterized as the

cumulative amount of the gross premium payments for a life insurance contract. Also, withdrawals of cash value or distributions from a life insurance contract will generally reduce the premiums paid to the extent of the nontaxable portion of the distribution. As John mentioned earlier, a contract's characterization as a MEC will be important, as it will determine the income ordering rules for identifying the taxable portion of the distribution. Since only the nontaxable amount of a distribution reduces premiums paid, identifying whether a contract is a MEC is necessary for properly adjusting premiums paid.

Mark: Great point. It's also interesting that deferring to the NAIC in defining "premiums" would provide only limited guidance as to some issues. Sections 72 and 101 refer to premiums and "other amounts" or "other consideration paid." So, even if an item isn't part of premiums for regulatory purposes, the policyholder might nevertheless get credit for investment in the contract or under the transfer-for-value rule if the item is "other consideration." In this sense, even full deference would be only half an answer for these provisions.

Peter: What about the cash surrender value? How is that defined?

Brian: Like premiums paid, section 7702 also provides for a somewhat circular definition of cash surrender value, defining it as the contract's cash value without regard to surrender charges, policy loans or reasonable termination dividends. However, the statute does not define the fundamental term cash value. Because of its importance in qualifying a contract under the CVAT or meeting the cash value corridor requirement for the GPT, insurance companies need to be able to properly determine a contract's cash surrender value. For most contract designs, determining the contract's cash surrender value is a relatively straightforward exercise and generally aligns with what is commonly referred to as the contract's policy or account value. However, for more complex product designs that provide for payments to policy owners in excess of or in addition to what would otherwise be available as a policy value, it becomes more challenging to precisely define the contract's cash surrender value, particularly given the currently available guidance.

The section 7702 definition of cash surrender value or, more broadly, the definition of cash value, has had a rather controversial past, having been the subject of several private letter rulings (PLRs) and a 1992 proposed regulation that attempted to provide a definition for the term cash value. The IRS is aware of the need for further guidance on defining cash surrender value and has been working on this initiative for some time now, having first appeared on their Priority Guidance Plan back in 2010. There was some expectation last year that guidance would be forthcoming, but with the recent turnover at the IRS and Department of Treasury, it seems to have delayed things for the time being.

To circle back to your first question, Peter, the Code does not explicitly refer back to the NAIC in determining premiums paid or cash surrender value as they relate to qualification under section 7702.

John: Brian, I agree with most of your comments, although I may have a different philosophical viewpoint about Congress' deference. When I think of the deference we are discussing, I view it as referring to congressional reliance on state law and state regulatory practices in the application of the tax statutes, and I believe those practices subsume a good deal of insurance tradition and the actuarial role in that tradition. Congress built section 7702, and section 101(f) before it, on this structure. You mentioned the applicable law rule in section 7702(a)—the requirement that a contract be treated as life insurance under the law of the jurisdiction in which it is issued—which Susan discussed earlier. The legislative history of section 7702 deems the applicable law to be state or foreign law, which as Susan indicated represents deference to the NAIC and the system of state insurance regulation for U.S.-issued contracts. Also, as you explained in detail, the statute uses the concept of a premium, both a net premium and a gross premium, to define the limits of a contract's permitted investment orientation. While Congress could have imposed a limit based on a present value concept as such, it reached instead into insurance tradition and concepts defined in and regulated under state law. For that matter, Congress defined the CVAT specifically to enable whole life insurance, as it had developed in insurance tradition and consistently with state regulation, to continue to qualify as life insurance for tax purposes. In doing so, Congress was acquainted with the meaning of "cash value" based on industry practice as of the early 1980s.

Peter: Brian mentioned several PLRs that provide guidance on the definition of cash surrender value. To me, that is a term of art in insurance lexicon and ought to be given some deference as John suggests, yet Brian notes that deference to the NAIC may be limited, at least according to the IRS. What was the IRS National Office's view on this issue in its rulings? According to the IRS, where do we look for a definition?

Mark: That's a good question, as deference may arise for different reasons in different circumstances. In Part I of this dialogue, we talked about reserves and we talked about examples where the Internal Revenue Code specifically instructs taxpayers and the IRS to use statutory concepts for federal income tax purposes. For example, section 807 incorporates CARVM (the Commissioners' Annuity Reserve Valuation Method) or CRVM (the Commissioners' Reserve Valuation Method) in the federally prescribed reserve, and the statutory reserve cap specifically refers to amounts set forth in the company's annual statement. (The same is true for property and casualty insurance reserves, by the way.)

CONTINUED ON PAGE 18

John points out that as a practical matter, Congress is acquainted with insurance tradition and regulation and those sources therefore have a role even absent a congressional instruction to defer. In fact, there is case law to the effect that where Congress uses terms that are terms of art in the insurance industry, the terms should be applied consistent with their usage in the industry. I'm thinking, for example, of cases like *Best Life*[6] and *Central Reserve Life*.[7] Those cases don't necessarily address product issues, but do provide a framework, or approach to interpreting the Code. I think of this framework as more than just a theoretical rule that courts or the IRS uses to interpret the statute, or even a rule that by design may provide the best evidence of what Congress means when it uses particular terms. For some non-tax technical product issues, the IRS would do well to benefit from the experience and work of non-tax regulators, or for that matter the actuarial profession. It is common sense that the tax system would look to the work of these professions as a starting point for defining product terms like annuity, or premium, or cash value.

In my experience, most companies take conservative positions in the product area so as not to create tax problems for their policyholders, and the IRS is less active in examining technical compliance in the area than in addressing broader issues like corporate-owned life insurance (COLI) and investor control. As a result, there's less guidance on life insurance product qualification, and the guidance that exists—the cash value proposed regulation, revenue rulings, notices, PLRs—is largely driven by the IRS. This, in turn, means that existing guidance may demonstrate more independence from non-tax concepts than a court would show.

Peter: Sheryl, was that your experience when you were the head of Chief Counsel's Insurance Branch? Did the IRS feel it could show independence from state regulatory rules in the product tax area?

Sheryl Flum: The starting point for a deference analysis differs significantly for company and product taxation purposes. In the company tax area, the Code refers directly to amounts, such as reserves, that are reported and visible on a company's annual statement. Products aren't specifically "reported on" in the same way for statutory purposes. But for the definition of cash surrender value, it's appropriate (and maybe even necessary) for the government to supply a definition for federal tax purposes because no regulator has crafted a workable definition, not even one that stems from industry tradition and common usage.

When we attempt to classify life insurance products into the various categories for federal tax purposes (i.e., life insurance, annuity, fixed or variable contract, etc.), there are instances where it is helpful to look to the statutory classification and there are also times where the regulator's classification is not appropriate for tax purposes. While I was the Branch Chief of the Insurance Branch, there were several instances where life insurance companies came in for PLRs and requested that the IRS treat the product for tax purposes differently than the product would be treated for regulatory purposes. One product that sticks out in my mind was an annuity that was treated as variable by the state, but was more appropriately classified as fixed under the Code. This is part of the reason why it is so difficult to come up with definitional guidance for life insurance products, and why deference to the NAIC should not be absolute.

Mark: Fair point. Peter and Susan talked earlier about the "applicable law" requirement in section 7702, that is, the requirement that for a contract to qualify as life insurance for tax purposes, it must be a life insurance contract under "the applicable law." They both rightly identified this requirement as an example of congressional deference to state regulators, because it basically looks to what is a life insurance contract under state law as a prerequisite to federal tax qualification.

I also think this is an issue where the National Office has shown a surprising degree of independence from non-tax regulation. The 1984 legislative history explains that to satisfy the applicable law requirement, a contract must be a life insurance contract "under the applicable State or foreign law."[8] Recall, federal law generally pre-empts the application of state law in situations where ERISA (the Employee Retirement Income Security Act of 1974) applies. And, under the McCarran-Ferguson Act, regulation of insurance is a matter left to the states, not the federal government. Nevertheless, a series of PLRs[9] in the late 1990s and early 2000s applies federal tax case law to conclude the applicable law requirement was met and death benefits paid under employee welfare benefit plans were excludable from gross income as they were paid under "life insurance contracts."

The "applicable law" PLRs were very controversial, and the competing tax policies could be the subject of their own dialogue. But for purposes of this discussion, I think it is fascinating that the IRS by PLR looked to law that neither technically governed the arrangements nor was state or foreign. One could quarrel over what it means for law to be "applicable." For ex-

ample, does it really need to apply and govern, or does it merely need to be relevant? But, the approach taken by the IRS in reverting to federal tax case law, which arguably was superseded by section 7702 itself, at least shows tremendous independence on the IRS' part and is a departure from what one usually thinks of as "deference."

Although the issue is not on the Priority Guidance Plan, for several years it has been identified as an issue that is "under study,"[10] meaning no further PLRs will be issued.

Sheryl: Given the contentious nature of the "applicable law" issue, I don't expect to see guidance in this area anytime soon. Nor do I expect to see the issue removed from the "no-rule" list. There are some open questions that are best answered by Congress.

Peter: So, the IRS has shown independent thinking as to the applicable law requirement. Is this also the case for the definition of cash surrender value?

Mark: For the cash surrender value definition, unlike the references to CARVM, or the annual statement, or even "applicable law," the Code itself does not specifically instruct the IRS and taxpayers to defer to state law or regulation. But, that doesn't mean they shouldn't do so.

Existing regulations under section 7702 were proposed in 1992 and define cash surrender value so broadly as even to require an exception for death benefits paid under the contract. This has been a matter of some controversy over the years and, as Brian points out, has been on the Priority Guidance Plan since 2010 without publication. One might reasonably ask: Why not define cash surrender value as the term is applied for state regulatory purposes? Wouldn't a court, for example, look to non-tax authorities to define such a term of art within the insurance industry?

I think on one level this lays bare an administrative conundrum that perhaps can't be avoided. That is, the breadth of the definition of cash surrender value under the existing proposed regulations would require companies to approach the IRS and ask for exceptions as issues emerge under new product designs. From an administrative perspective, it is better for the IRS if there is dialogue upfront around new product features. Merely deferring to state law or regulatory definitions of cash value could in some cases leave the IRS in the position of needing to add to the definition of cash value to accommodate product features that frustrate tax policy as the IRS interprets it. One might not necessarily expect companies to come in and discuss such circumstances.

With or without deference, and whether a broad definition of cash value or a narrow one, administration of this area and adaptation to new products are hampered by the difficulties in producing timely guidance that responds to new products.

Sheryl: It's true that product innovation stays ahead of tax rule changes, and that likely will always be true. I don't think this means the IRS should give up on its efforts to provide guidance, though, as taxpayers generally appreciate having more rather than less information from the IRS regarding its position on product issues. The process for publishing guidance is very time-consuming due to the level of review afforded. However, the IRS has issued timely private guidance on new products as they are being developed. It is important for insurance companies to consider requesting a PLR as part of the product development process if the tax treatment for the product is not clear. Since the amount of published guidance is limited, it is also imperative that the insurance industry continue to communicate with the IRS and Treasury on which issues should be prioritized.

With regard to the definition of cash surrender value, having the proposed regulation remain on the books, so to speak, has caused problems for the IRS to issue PLRs on certain life insurance features. Even though the proposed regulation has never been finalized and taxpayers and courts are not obligated to rely on it, unless and until the proposed regulation is finalized or withdrawn, it reflects the IRS' position and the IRS must follow it. Thus, the IRS could not issue rulings on contract designs that have, for example, critical illness riders. Because the best way to get timely guidance on a product design is by PLR, and the proposed regulation is hampering the issuance of the private guidance, it is important for the IRS and Treasury to act.

Peter: John, at this stage I think it would be a good idea to proceed with the discussion of long-term care (LTC) insurance and ADBs that you deferred earlier. As before, can you give us a short overview of the policyholder tax rules for the LTC product and the rules governing ADBs?

John: Sure. LTC insurance first was developed, I believe, in the 1980s, but the tax treatment of LTC insurance benefits was unclear. It seemed possible that the benefits would be tax-free as accident and health insurance

CONTINUED ON PAGE 20

benefits under section 104, but the deductibility of the premiums was in doubt since the coverage went beyond the scope of insurance for medical expenses, and the treatment of employer-provided coverage was quite uncertain. In the Health Insurance Portability and Accountability Act of 1996—HIPAA—Congress stepped in to clarify the tax treatment of LTC insurance coverage, provided that the coverage met a then-new definition of "qualified" LTC insurance enacted as section 7702B. According to that statute, if the coverage is qualified, then the benefits that reimburse LTC expenses are excludable from income under section 104, an employer plan providing the coverage is treated as an accident and health plan, benefits paid on a per diem basis are excludable subject to specified dollar limits, and the premiums are deductible as medical insurance within limits.

Under section 7702B, in very general terms, an LTC insurance contract is qualified if it is guaranteed renewable and provides coverage only of a statutorily specified list of services needed by a chronically ill individual, whom the statute defines as a person certified as needing prescribed assistance in performing two of the six activities of daily living or due to severe cognitive impairment. Also, the contract may not provide a cash surrender or loan value, although in limited circumstances it can pay a refund of premiums, and the issuing insurer must offer a nonforfeiture benefit. In terms of deference to the NAIC, subsection (g) contains a formidable list of consumer protection requirements drawn from the 1993 Long-Term Care Insurance Model Act and Model Regulation that a contract must meet in order to be qualified, and beyond this, penalty taxes are imposed on the issuing insurer unless it complies with additional NAIC-prescribed requirements in the Model Act and Model Regulation. Further, a section 7702B regulation finalized in 1998 treats compliance with state law as compliance with such requirements where a state enacts requirements comparable to those of the Model Act and Model Regulation.

The definition of a qualified LTC insurance contract acts as a safe harbor, in that the Code does not expressly specify the tax treatment of LTC insurance coverage that is not qualified.

Peter: And what about ADBs?

John: The acceleration of death benefits—the payment of all or a portion of a life insurance contract's death benefit while the insured is still alive—also dates from the 1980s, when insurers began offering ADB payments for terminally ill insureds. Since nothing in the tax law classified ADBs as death benefits excludable from income under section 101(a), the Treasury Department took the step of deeming them to be excludable under certain conditions in regulations proposed in 1992. The regulations also addressed ADBs that were then being offered if the insured became chronically ill. Those regulations were never finalized, but Congress took up the matter in HIPAA, enacting section 101(g) to treat ADBs as equivalent to death benefits where the insured was certified by a physician as having an illness or condition likely to result in death within two years. HIPAA also extended death benefit treatment to ADBs under both section 101(g) and section 7702B for insureds certified as chronically ill, subject to the limits imposed by section 7702B on per diem payments. For an ADB that constitutes qualified LTC insurance under section 7702B, compliance with the consumer protection rules of the NAIC's 1993 Model Act and Model Regulation referenced in the statute is required. For other ADBs, section 101(g) mandates compliance with NAIC rules, if any, applicable to the ADBs, or to more stringent rules under state law in order for the benefits to be tax-free.

In the mid-2000s, interest also arose in combining qualified LTC insurance with a nonqualified annuity contract, so that the annuity's benefits could be paid out when an individual became chronically ill. Since qualified LTC insurance cannot provide a cash surrender value and can only cover qualified LTC services, it was unclear whether such a combination was permissible under section 7702B, but again Congress stepped in to clarify matters. In the Pension Protection Act of 2006, section 7702B was amended to enable the annuity-LTC combination product to move forward.

Peter: Susan, has the IRS shown deference to the NAIC and state regulators in its administrative guidance on LTC insurance?

Susan: As John says, the statutory language of section 7702B and the regulations issued under that section rely heavily on the requirements of NAIC's 1993 Model Act and Model Regulation and give explicit deference generally to state regulators that have comparable requirements. In this regard, I think that the industry has been lucky that the deference is built into the statute because the IRS has not been particularly forthcoming with additional tax guidance for LTC insurance products. For example, there has been an item in the Insurance Companies and Products portion of Treasury's Priority Guidance Plan for "Guidance on annuity contracts with a long-term care insurance feature under §§72 and 7702B" since the 2009–2010 Plan. The 2011–2012 Plan announced the publication of Notice 2011-68 under this LTC item and, although that Notice requested comments by Nov. 9, 2011, there has been no further action taken and no additional general guidance. The Priority Guidance Plans since the 2012–2013 Plan have continued to include the same item referring to LTC insurance, with a slight modification in the description—that is, "Guidance on annuity contracts with a long-term care insurance rider under §§72 and 7702B." In addition, the Priority Guidance Plans since the 2012–2013 Plan have included a second LTC insurance item, which is "Guidance on exchanges under §1035 of annuities for long-term care insurance contracts." Other than recognizing that additional guidance on LTC insurance tax

issues may be important, I don't think that the issue of deference to the NAIC and state regulators (or not) has really come into play for the IRS from an administrative perspective.

Mark: That's certainly true in recent years, though I think the regulations you refer to on the consumer protection provisions of section 7702B are themselves an interesting case study in deference. First, as to those provisions, deference was arguably a foregone conclusion because the Code itself refers to the NAIC Model Act and Regulations. Second, deference was entirely appropriate as a matter of policy because the NAIC and state regulators are in a much better position to prescribe rules to protect consumers than are the IRS and Treasury. Other areas arguably fall in the same category. For example, section 7702B defines "chronically ill individuals" by reference to the ability to perform activities of daily living—ADLs—and requires the Secretary of the Treasury to prescribe regulations in "consultation" with the Secretary of Health and Human Services. Section 101(g) defines "terminally ill insureds" and "chronically ill insureds" by reference to NAIC guidance on viatical settlements. Wisely, Congress recognized that the IRS and Treasury alone lack the expertise to prescribe rules in these areas without at least consulting non-tax regulation. The guidance projects that Susan has listed from the Priority Guidance Plans since 2009 relate primarily to the Pension Protection Act provisions addressing combination contracts and exchanges for LTC contracts. I totally agree one would think of those projects as not implicating deference directly, though hopefully whatever guidance the IRS has been working on since the 2011 notice would take into account the common terms of those contracts and whatever regulatory requirements apply to them.

Wisely, Congress recognized that the IRS and Treasury alone lack the expertise to prescribe rules in these areas without at least consulting non-tax regulation.

Sheryl: Unfortunately, the IRS' limited resources are to blame for the lack of guidance for qualified LTC riders on annuities and exchanges under section 1035 of annuities for LTC insurance contracts. Even though earnings that are distributed from an annuity are generally taxable, Congress appears to have specifically over-ridden that treatment when the annuity is used to fund LTC coverage. This issue, though, is not really a question of deference to the NAIC or state regulators, but is more of a tax administration concern. The IRS and Treasury need to establish rules to carry out congressional intent and that is what the much-anticipated guidance should provide.

Peter: But, do you expect guidance actually to be issued?

Sheryl: Guidance is needed, but with the IRS budget constraints, I do not expect to see anything soon.

Brian: Sheryl, carrying forward your thoughts on tax administration concerns, ADB riders also create administrative challenges under sections 7702 and 7702A. When a triggering event occurs that accelerates the payment of a death benefit, contracts still need to satisfy the section 7702 requirement and companies will still need to monitor for compliance with the 7-pay test to determine whether contracts are MECs. Like exchanges under section 1035 of annuities for LTC insurance, there are a number of administrative questions that surface when trying to figure out how the adjustment rules in sections 7702 and 7702A apply to the payment of an ADB.

First, let's talk about the section 7702 requirements. While there are different product designs, a common feature of an ADB rider is to reduce both the death benefit and the cash value of the contract proportionately when there is an acceleration of death benefit. The CVAT is much better equipped to accommodate this type of design, while still allowing the contract to qualify with section 7702. The CVAT is prospective in its application and is a proportional-based test that manages the relationship between cash value and death benefit. Proportional changes to both the death benefit and cash value resulting from the payment of an ADB reconcile well with the CVAT requirements, as the same relationship between cash value and death benefit is maintained both before and after an ADB is paid.

Determining how to deal with the payment of an ADB under the GPT is a bit more challenging. While it is clear that death benefits are reduced as a result of an ADB payment, there are a host of questions that come up with how to account for the payment of an ADB under both the guideline premium and the 7-pay test. Some have questioned whether the traditional attained age adjustment methodology under section 7702 results in a "proper adjustment" to guideline premiums for the payment of an ADB. Similarly, which of the two adjustment rules under section 7702A, if any, should apply: the material change rules of section 7702A(c)(3) or the reduction in benefit rules of section 7702A(c)(2)? Further, to the extent the contract's cash value is reduced as a result of an ADB, should there be corresponding adjustment to premium paid? I think it's fair to say that the drafters of sections 7702 and 7702A did not have ADBs in mind when developing the statutory requirements for life insurance contract qualification.

CONTINUED ON PAGE 22

To date, no regulations or other guidance have been issued regarding the effect of ADBs on premiums paid and how to account for ADBs under the adjustment rules of sections 7702 and 7702A. We can add these administrative items to those mentioned by Sheryl and Susan where additional guidance from the IRS and Treasury would be helpful.

Mark: Perhaps this discussion comes full circle. We talked earlier about the existing proposed regulations on the definition of cash value, and the Priority Guidance Plan project that may one day take a fresh look at that issue. The existing proposed regulations were published before Congress added section 101(g) to the Code. At least part of the impetus for including the definition of cash surrender value on the Priority Guidance Plan was a sense that updating those regulations to acknowledge the enactment of section 101(g) would simply be a matter of good housekeeping. The existing proposed regulations are a lesser priority to the industry than other guidance, but if the IRS reaches the point of considering them, it would indeed be helpful if they used the opportunity not only to address cash value but to address other ADB issues you mention, Brian, like application of the adjustment rules, or the effect on premiums paid. It's hard to imagine them doing so without thoroughly weighing the nontax treatment of ADBs by the NAIC and by state regulators. In the product space, there is much to be said for a starting point that is cognizant of nontax regulation, whether or not there is a statutory instruction to defer.

Peter: This has been an interesting dialogue and I think it is fair to say that our conclusions have not been as certain as in our first dialogue on tax reserves. Whereas there was general consensus in Part I of our dialogue that deference to the NAIC's tax reserve method is required regardless of arguments by the IRS to the contrary, we do not have a similar consensus that deference to the NAIC or state regulation is required on many important product tax issues. Perhaps, that is because, as we mentioned, companies need to be sure that their products will not fail and, therefore, as a practical matter must avoid controversy and defer to IRS guidance, whether or not it conflicts with NAIC or state regulatory rules.

I want to thank the panelists again and look forward to the upcoming third, and final, installment of our dialogue. ■

Note: The views expressed herein are those of the authors and do not necessariy reflect the veiws of their current or former employers.

ENDNOTES

[1] Section 1035(b)(3).

[2] Section 817(h) requires that a variable life insurance contract based on a segregated asset account will be treated as life insurance only if the assets in the account are adequately diversified.

[3] Section 1035(b)(1) defines an endowment contract as a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

[4] Section 72(s).

[5] Section 1035(b)(2) defines an annuity contract as an endowment contract, but which is payable during the life of the annuitant only in installments.

[6] *Best Life Assurance Co. v. Comm'r,* 281 F.3d 828 (9th Cir., 2002).

[7] *Central Reserve Life Corp. v. Comm'r,* 113 T.C. 231 (1999).

[8] H.R. Conf. Rept. No. 861, 98th Cong. 2d Sess. 1075 (1984), 1984-3 (vol. 2) C.B. 329.

[9] PLR 200002030 (Oct. 15, 1999), PLR 199921036 (Feb. 26, 1999).

[10] Rev. Proc. 2015-3, 2015-1 I.R.B. 129, section 5.01(2) (Jan. 2, 2015).

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com.*

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

Sheryl Flum is managing director, Washington National Tax with KPMG LLP and may be reached at *sflum@kpmg.com.*

Susan Hotine is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *shotine@scribnerhall.com.*

Brian G. King, FSA, MAAA, is an executive director, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at *Brian.King3@ey.com.*

Mark S. Smith is a managing director in PwC's Washington National Tax Services and may be reached at *mark.s.smith@us.pwc.com.*