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In the Beginning… A Column Devoted to Tax Basics

Premiums Paid, Investment in the Contract, and Tax Basis – We Know It When We See It, Right?

By John T. Adney

The federal income tax law was once described by a federal judge as a conspiracy in restraint of understanding. While people—including tax professionals—at times feel that way, there are some terms in the tax law that appear reassuringly simple. And yet some of those terms are deceptively simple. This edition of the "In the Beginning" column devotes itself to exploring, at a basic level, the tax meaning of three concepts that are fundamental to the income taxation of life insurance products: premiums paid, investment in the contract, and basis.

The concepts of "premiums paid" and its companion term, "amount paid," must be understood in order to implement, respectively, the guideline premium test of section 7702 and the modified endowment contract (MEC) rules of section 7702A.[1] The "investment in the contract," properly calculated, is employed to determine the amounts of life insurance and annuity contract distributions that are includible in gross income for tax purposes and reportable as such by insurers. And "basis," sometimes called "tax basis," is important in determining taxable gains when contracts are sold or are exchanged in a manner that is not income-tax free.

Any exploration of these terms must start with the concept of "premium." One does not need to be an actuary to comprehend the common meaning of an insurance contract premium. We all pay them, for life, auto, home and other insurance coverages, so we may assume that we know a premium when we see one.[2] The Congress of the United States apparently thinks so, too, in that it has instructed those charged with calculating guideline premiums and 7-pay premiums to calculate a "premium" using certain specified actuarial assumptions but without further definition, and it also said to determine the "premiums paid" under section 7702 by looking to "the premiums paid under the contract," albeit subject to certain adjustments discussed hereafter.[3] It could be that "premium" must join "income" and "reasonable" in the Internal Revenue Code's lexicon of irreducible terms.

But even if we know what a premium is, what is meant by "premiums paid" as it appears in section 7702(f)(1)? And how about the companion term "amount paid" in IRC section 7702A(e)(1)? To be clear, "premiums paid" is used to measure whether the cumulative premiums paid (please excuse the redundancy) for a contract at any time do not exceed the contract's guideline premium limitation under section 7702(c) at that time, a necessity if the contract is to qualify for the normal tax treatment of life insurance.[4] Comparably, "amount paid" is employed to track the amount and timing of each premium paid for a life insurance contract to determine whether the contract is or has become a MEC within the meaning of section 7702A(a).

For these purposes, the Code spells out some details. Specifically, section 7702(f)(1) defines "premiums paid" as the premiums paid (again, excuse the redundancy) under a contract less four items:

- Distributions, other than amounts included in gross income, to which section 72(e) applies;
- Any excess premiums with respect to which there is a distribution described in section 7702(f)(7)(B) or (f)(7)(E);
- Any amounts returned to the policyholder—with interest—within 60 days of the end of a contract year in order to comply with the guideline premium test; and
- Any other amounts received with regard to the contract that are specified in regulations.

This impressive list of reductions in premiums paid—and reductions are good news for attaining compliance with the guideline premium test—warrants a little explanation. The first item, "distributions," refers to amounts paid from or under a contract that are not taxable, such as policyholder dividends and partial withdrawals that are treated as recovering investment in the contract (which will be defined later) under the rules of section 72(e).[5] The second item, "excess premiums," is more complex to explain, but suffice it to say that they are amounts subjected to tax by virtue of section 7702's "recapture ceiling" rules—rules that today tend not to be significant apart from section 1035 exchanges.[6] The third item is even more

complex in operation, but in essence it encompasses premiums previously paid that are returned to the policyholder promptly after the contract year-end and with interest.[7] In contrast, the fourth item is easy to explain: there are no regulations implementing it, so for practical purposes it doesn't exist.

As for the MEC rules, section 7702A(e)(1) contains a somewhat simpler definition of "amount paid," stating that it consists of the premiums paid[8] under the contract, less distributions described in the first and third items above, with one modification. Hence, in determining the amount paid for section 7702A testing purposes as of any time, the cumulative premiums paid to that time generally are reduced by (1) amounts paid from or under a contract that are not taxable because they are treated as recovering investment in the contract under section 72(e) and (2) premiums previously paid that are returned to the policyholder promptly after the contract year-end and with interest. The modification is that amounts borrowed, assigned or pledged under a contract are not treated as paid from or under the contract, as they otherwise would be in the case of a MEC.[9]

While the section 7702(f)(1) definition thus shares some common ground with the section 7702A(e)(1) definition, the two diverge markedly in the case of a contract exchange, such as an exchange that is tax free under the section 1035 rules. For section 7702 purposes, the premiums paid include the value coming into the new contract from the replaced contract, *i.e.*, usually the value received by the new insurer in the exchange that is treated as premium for annual statement purposes. However, because of a special rule developed for section 7702A because of that statute's sensitivity to how rapidly premiums are paid for a contract (it typically doesn't approve of contracts that are quickly paid up), the amount paid does not include the value coming over from the replaced insurer. Rather, pursuant to the section 7702A(c)(3)(A)(ii) "rollover rule," a downward adjustment is made to the 7-pay premium—the amount allowed to be paid without creating a MEC—to account for the cash value arising out of the exchange.

Now that the concept of premiums paid (and amount paid) as used for section 7702 and 7702A purposes is perfectly clear, it remains important to examine the role that the concept plays in determining the investment in the contract and in measuring tax basis. In particular, it is vital to understand the manner in which the several definitions diverge.

The "investment in the contract," as noted above, functions to determine the taxable amounts of life insurance and annuity contract distributions. (Since the death benefit paid under a life insurance contract typically is income-tax free, the life insurance distributions of concern here are ones made while the insured is living; annuity benefits, whether paid before or after death, usually are taxable.) The definition of the investment in the contract as relevant to distributions that are taxed as "amounts not received as an annuity," such as partial withdrawals and complete surrenders, is found in section 72(e)(6).[10] In that provision, the investment in the contract as of any date is said to equal "the aggregate amount of premiums or other consideration paid for the contract before such date minus the aggregate amount received under the contract before such date, to the extent such amount was excludable from gross income…." (It appears that the phrase "other consideration" is used in the statute to accommodate annuity contributions, exchange proceeds to a limited degree (see below), or similar items that some may not colloquially think of as premiums.) Thus, in general, the investment in the contract is calculated as the premiums paid, less prior contract distributions that were not taxed. It should be noted that the investment in the contract is sometimes called "cost basis," and while there is nothing inherently harmful in so referring to it, it should

not be confused with "basis" in the formal sense that the latter term is used in the Code, discussion of which will occur at the end of this column.

This definition of investment in the contract looks comparable to that of premiums paid under section 7702(f)(1) using only the first of its four listed reduction items. However, the two definitions differ in their treatment of contract exchanges covered by section 1035. As previously noted, section 7702(f)(1) premiums paid concept includes the value received from the replaced contract, but not so the section 72(e)(6) investment in the contract. Because section 1035 confers tax-free status on the exchange, the investment in the contract given up in the exchange is said to "carry over" to the new contract, so that the investment in the contract issued in the exchange starts with the investment in the old contract (the premiums previously paid for it less any untaxed distributions from it) and then is increased by any premiums paid for the new contract less any untaxed distributions from the new contract.

Another instance of a difference arises where a loan, assignment or pledge is made under a MEC, for that can trigger gain recognition under section 72(e)(4)(A). In such a case, the investment in the contract is increased by the amount includible in income, although the section 7702(f)(1) premiums paid remains unaffected.[11] It is important for insurance company tax monitoring and reporting systems to take these differences into account.

The treatment of premiums paid or charges made for benefit riders to contracts, as well as the treatment of the benefits paid under certain riders, also can play a role in determining the investment in the contract and may affect the section 7702(f)(1) premiums paid. One question currently under consideration by the Internal Revenue Service (IRS) and the Treasury Department, as disclosed in their Priority Guidance Plan, is the effect that benefit payments made under a qualified long-term care rider to an annuity contract have on the investment in the contract. Such payments may be income-tax free to the recipient, and to the extent they are, they could be viewed as untaxed distributions that, as a general matter, reduce the investment in the contract. These payments are unusual, however, in that they contain a pure insurance element and thus consist only partly of premiums previously paid for the contract. It remains to be seen what the government will say on this topic. The manner in which premiums and charges for benefit riders and benefit payments from them should be accounted for under sections 7702 and 72 is a voluminous subject that extends well beyond the scope of an "In the Beginning" column, but it is a subject worthy of in-depth study by those charged with tax compliance duties.

Life insurance and annuity contracts, as noted at the outset, also may be sold or may be exchanged in a taxable transaction (*i.e.*, where section 1035 does not apply). In the sale situation, a provision in section 72 speaks to adjustment of the investment in the contract in the hands of the new owner, a/k/a the buyer. Specifically, section 72(g) says that where a "transfer for value"

of a life insurance or annuity contract has occurred and there is not a "carry over" of the basis (see below) that existed in the hands of the former owner (the seller), the buyer's investment in the contract consists of the "actual value of [the] consideration" paid by the buyer to acquire the contract plus any premiums or other consideration the buyer paid post-acquisition. Also, in determining the reduction of the investment in the contract by untaxed distributions, only those received by the buyer are factored into the buyer's investment; untaxed amounts received by the seller are irrelevant for this purpose, although not for the seller's own taxation, as discussed below.

In this connection, we may note that a rule parallel to section 72(g) exists in section 101(a)(2), the "transfer for value" provision that typically is more familiar to denizens of the life insurance industry. Section 101(a)(2) does not use any of the talismanic words otherwise considered here, but describes the treatment of a life insurance contract sale in the hands of the buyer in straightforward terminology. In plain English, it limits the exclusion of life insurance death proceeds otherwise allowed by section 101(a)(1) to the same amount that section 72(g) says is the buyer's investment in the contract. Thus, the death proceeds above that amount are taxable to the buyer as ordinary income. It is section 101(a)(2)(A) that references the "carry over" of basis mentioned above, providing that a transfer for value limitation does not apply where the basis of the new owner is determined by looking to the basis of the former owner.

Apart from section 72(g), the concept that most comes into play in a contract sale setting, as well as in the case of a taxable exchange,[12] is formally called "basis." In this sense, basis (sometimes called tax basis) serves as a determinant of taxable gain in circumstances in which an amount is not received under a contract in the sense of section 72 but rather is realized outside of it, as where a seller of a contract receives payment from a buyer or where the gain existing in a contract at the time of a taxable exchange is deemed to be realized by the policyholder. In these circumstances, the taxable gain that must be recognized under section 1001 (not section 72) equals the amount received (or deemed to be realized) in excess of the seller's or policyholder's basis. Such basis is technically determined under section 1012 (generally referencing the "cost of the property"), subject to adjustment as provided in section 1016.

As such, the calculation of the basis of a life insurance or annuity contract generally follows the same rules that determine the investment in the contract under section 72. Even so, there can be differences. One such difference that the IRS has fairly recently insisted on is that the basis of a life insurance contract should be adjusted downward to account for the cost of insurance.[13] This is not done in determining the investment in the contract, and not surprisingly, the IRS's view has been roundly criticized by life insurers, contract sellers, and contract buyers (*i.e.*, the life settlement industry), and legislation has been proposed in Congress to reverse the agency's position.

By way of conclusion, in this column we have "scratched the surface" of the tax law's rules governing premiums paid, investment in the contract, and basis. The purpose here has been to provide the reader with some basic definitions of these concepts and, importantly, to identify instances where they differ from one another even though they may appear to look alike. Much more can be said about this subject, and perhaps one of the readers of this column will one day provide us with instruction that delves into additional details. ■

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.*

ENDNOTES

1 To simplify matters, all references to "section" should be read as referring to sections of the Internal Revenue Code of 1986, as amended (Code or IRC).

2 This is the case even if we do not know that the notion of a "premium" dates back at least to the Renaissance and is based on the extra charge (a premium rate, if you will) paid by marine shippers of cargo to assure that the sinking of a ship carrying their cargo would not result in financial loss to them.

3 IRC section 7702(f)(1). Congress also told each insurance company to include premiums in calculating its own gross income, without much definition of the term apart from the need to follow, more or less, the reporting used in the company's NAIC-prescribed annual statement. *See* IRC sections 803(a), 811(a).

4 The contract could, alternatively, meet the IRC section 7702 definition by complying with the cash value accumulation test, but only if it complies with that test by its terms.

5 Note that policyholder dividends retained by the insurer to pay premiums for a MEC are not treated as income pursuant to IRC section 72(e)(4)(B).

6 More detail concerning these rules can be found in chapter 4 of *DesRochers et al., Life Insurance & Modified Endowments, Second Edition* (Society of Actuaries 2015).

7 The reader should not view this statement as diminishing the significance of this rule as a device for saving contracts from non-compliance with the guideline premium test. *See* DesRochers et al, supra note 6, at 30–31.

8 We will now cease apologizing for the congressional redundancy.

9 *See* IRC section 72(e)(4)(A).

10 A companion definition for annuitized payments appears in IRC section 72(c).

11 A subsequent payoff of the loan or release of the assignment or pledge has no effect on the investment in the contract.

12 While most contract exchanges will be structured so that they are covered by IRC section 1035 and are thus income-tax free, not all can be. For example, if a jointly owned contract is subsequently divided via an exchange such that each former joint owner holds his or her own contract (albeit a smaller one than before), IRC section 1035 would not apply. The same would be true of a joint and last survivor contract that was divided, in effect, between the two insureds. Also, in Rev. Rul. 90-109, 1990-2 C.B. 191, the IRS concluded that a change of the party insured under a business-owned contract pursuant to a change-of-insured rider constituted a taxable exchange under IRC section 1001.

13 *See* Rev. Rul. 2009-13, 2009-21 I.R.B. 1029.