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# In the Beginning… A Column Devoted to Tax Basics

## Why Section 7702 (and 7702A, too)? Some Historical Perspectives

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In the deep, dark mists of pre-history, say around 1980, the Internal Revenue Code made no effort to define the term "life insurance contract" in a thorough-going fashion, even though it used the term (or referenced its alter ego, "life insurance policy") many times. True, the term "life insurance contract" was defined in Section 1035,[1] but only for purposes of applying the tax-free exchange rules of that provision. Instead, recognition of a contract as life insurance for federal tax purposes generally was based on the contractual form of the coverage provided, subject to common law (judge-made) rules requiring, *e.g.*, that the arrangement involve the shifting and distribution of mortality risk.

This began to change in 1982, in reaction to the development of a new generation of life insurance products that featured a dazzling array of innovations and creative names to go with them. Prompted in part by the beginnings of the cyber revolution in the 1960s and in part by the advent of high interest rates and inflation of the 1970s, the life insurance industry brought forth products that were more flexible and attractive to consumers than the industry's historic offerings. The insurance marketplace thus witnessed the arrival of Northwestern Mutual's Extraordinary Life, Adjustable Whole Life introduced by Minnesota Mutual (now Minnesota Life) and Bankers Life of Iowa (now Principal Life), variable whole life as first marketed by The Equitable (now AXA), term insurance and annuity combinations hawked as substitutes for whole life, indeterminate or nonguaranteed premium whole life products, interest sensitive whole life plans such as Executive Life's Irreplaceable Life, and ultimately the flexible premium adjustable life insurance contract everyone knows today as universal life.

It was a taxation crisis of sorts enveloping universal life that fomented, in 1982, the first congressional foray into defining life insurance in the Internal Revenue Code. The Internal Revenue Service had issued favorable rulings on the income tax treatment of universal life in the prior year,[2] but soon began having second thoughts on the subject, and by May of 1982 the agency concluded that it should withdraw those rulings. This prompted the companies issuing the new product to seek help from Congress, which obliged by enacting Section 101(f) in the Tax Equity and Fiscal Responsibility Act of 1982. While the new statute specifically addressed the flexible premium universal life insurance product to assure its tax treatment as life insurance, the legislation also imposed limits on the amount of premiums that could be paid for the product, constraining the product's possible use as mainly a tax-preferred savings vehicle (sometimes called investment orientation) and thereby allaying the tax policy concerns underlying the IRS's discomfort with the rulings it had issued. But Congress made those rules temporary and immediately undertook the crafting of a new Code Section dedicated to defining "life insurance contract" for all purposes of the Code. This work resulted in the creation of Section 7702 in 1984, and while the new section was modelled on the temporary rules, its reach extended to all forms of life insurance.[3] Then, following on the heels of a major reform of the federal tax law in 1986, Congress enacted Section 7702A in 1988, defining a new tax creature called a "modified endowment contract" (or MEC) and substantially altering the tax treatment of pre-death distributions from life insurance contracts that meet the MEC definition.[4]

What led Congress to take such steps? In other words, why do Sections 7702 and 7702A exist? And, to what are some of the two statutes' more notable features attributable? The answers require an exploration of the pertinent life insurance and political history along with a review of certain aspects of federal income tax policy. Let us begin.

### THE RISE OF SECTION 7702

As the ink was drying on the 1982 legislation that enacted Section 101(f), the realization was setting in that the advent of newer types of life insurance products warranted a formal reaction within the federal income tax law. In addition to flexible premium universal life, fixed premium versions of that product had made an appearance, and single premium products with guaranteed increases in their death benefits—and hence containing small amounts of pure insurance risk relative to their build-up of cash values—found a willing group of buyers among those seeking tax-efficient investments. Within a year after the enactment of Section 101(f), the Treasury Department noted in testimony before the House Ways and Means Committee that the investment features of insurance

products were increasingly emphasized in the marketing of those products. In particular, the Treasury suggested that Congress consider whether single premium life insurance policies, and life insurance policies that endowed at an early age, should be treated as life insurance for federal tax purposes.

The question that all of these new products posed for tax policy could be reduced to this: how much pure insurance risk must a contract provide to be treated as life insurance rather than as a deferred annuity, a mutual fund, or a form of debt or equity investment? The stakes here were high, both for the Treasury and for the life insurance industry, as the life insurance contract benefitted from non-taxation of its death benefit and of its cash values (the inside build-up) prior to any distributions during the insured's life, and also, at the time, from the treatment of pre-death distributions as first recovering investment in the contract and the treatment of borrowing against that cash value as merely a non-taxable loan. In contrast, distributions of income from a deferred annuity were fully taxable, and, compliments of the 1982 legislation, distributions other than annuity streams were considered to carry out income first, possibly with a penalty tax. Further, interest credited to bank accounts was taxable when credited, whether or not withdrawn, and dividends paid by mutual funds or by corporations on their shares of stock were likewise currently taxable. Some in the tax policy community therefore asked, why is the inside build-up of life insurance not taxed as it accumulates? (Indeed, this question was posed as part of the Treasury's Ways and Means testimony.) Moreover, the early 1980s was a period of very high interest rates—when considering just how investment-oriented Section 101(f) permitted a universal life contract to be, it was said that the Treasury Department tested the results under the statute then being drafted assuming a "reasonable" long-term interest rate of 12 percent. Hence, tax-deferred accumulations, always of some value, enjoyed a particularly high value, and that value was even greater when they ultimately became tax-free.

With this in mind, Congress embarked on the line-drawing exercise that became Section 7702, unveiling the first version of the statutory draft in the fall of 1983. From that first version, it was clear Congress was willing to leave the inside build-up of life insurance untaxed so long as the build-up was limited and remained inside. Accordingly, it can be said that the principal reason Section 7702 exists is to preserve the historic tax treatment of the inside build-up, *i.e.*, that the build-up of cash values under a permanent life insurance contract is not to be taxed as it accrues simply because it accrues, and that this build-up may pass to the death beneficiary free of income tax.[5] The proviso that Section 7702 layers onto this, however, is that the historic treatment remains only if the contract provides a death benefit that is at least a minimum multiple of the contract's cash surrender value (ignoring surrender charges), *i.e.*, only if the contract provides at least a minimum amount of pure insurance protection or "net amount at risk." The minimum so defined is at the heart of the statute's line-drawing exercise.

## How much pure insurance risk must a contract provide to be treated as life insurance?

As actuaries know, the minimum net amount at risk required under a contract striving to qualify as life insurance is defined by Section 7702 in actuarial terms. This was done because the model employed as the general limit on the investment orientation allowed for a life insurance contract was itself an actuarial construct: the single premium whole life insurance contract.[6] Hence, for a contract to be in compliance with the statute's "cash value accumulation test" (or CVAT), its cash surrender value cannot, by the terms of the contract, exceed the net single premium (NSP) for the contract's death benefit.[7] And recalling the evil of the single premium contract with a guaranteed increasing death benefit, Congress made it clear in the statute the death benefit used in determining this NSP cannot be increasing. In addition, since Section 7702 was modeled on the Section 101(f) temporary rules for universal life contracts, it continued the practice of allowing contracts to meet its requirements by complying with an alternative set of limitations, *i.e.*, the "guideline premium test" and its companion "cash value corridor."[8] Unlike the CVAT, which focused on the relationship between a contract's cash value and its death benefit and required a minimum pure risk amount separating these two, the guideline premium test directly restricted the gross amount of premiums that could be paid for a contract relative to the contract's death benefit, again employing actuarial concepts. It also mandated, via the cash value corridor, that in any event a minimum risk amount must remain in the death benefit being provided, at least until the insured reached age 95.

Accordingly, the statute provided two paths by which permanent life insurance contracts—those providing for a cash value build-up—could comply with its limitations and avoid the taxation of the inside build-up. The CVAT was designed to enable compliance by whole life contracts, while the guideline premium test and cash value corridor were written to accommodate (and limit the investment orientation of) flexible premium universal life, although the statute technically made both of its compliance paths available to both types of contracts.

While the two paths were viewed at the time as more or less equivalent, they diverged in a number of respects. The CVAT was built on the premise that the NSP must use an interest rate assumption of at least 4 percent—the thought being that that was a reasonable long-term interest rate and surely rates would not fall below such a figure—while the guideline single premium was required to be calculated using not less than 6 percent. Hence, the amount of a single premium that could be paid into a contract tested for compliance using the CVAT was materially larger than that which could be paid for a contract subject to the guideline premium test. On the other hand, the minimum risk amount required by that test's cash value corridor was lower, as a function of the contract's cash value, than was the case under the CVAT. This result could be thought of as a trade-off engineered to bring about overall equivalence between the two paths, although the history of the enactment may not support such a view.

As noted earlier, Section 7702 was enacted in light of, and in support of, the congressional decision to leave the inside build-up of life insurance untaxed solely because it builds up over time. The deal was: the historic tax treatment of the inside build-up would be preserved, so long as the limits imposed by the CVAT or the guideline premium and corridor tests are respected. To make this perfectly clear, the statute spells out the tax treatment of what has become known as a "failed" life insurance contract, *i.e.*, the interest or earnings credited to the contract are taxed in the year credited, with no offset for the cost of insurance charges, although the net amount at risk may still pass to the death beneficiary free of income tax.[9] In this respect, it may be said that Section 7702's limits perform a second function, namely, to draw lines differentiating the tax treatment of life insurance from that of annuities, mutual funds, and various forms of debt and equity investments.

By the way, the reader may want to note that Section 7702, for all its words and references to actuarial concepts, makes no effort to define a term even more fundamental than life insurance: the term "insurance" itself. The statute is premised on the understanding that insurance, within the meaning of the tax law, is present within the life insurance contract to which it refers. Answering the question "What is insurance?" remains the subject of continuing court cases and IRS rulings.

## THE (BUMPY) ROAD TO SECTION 7702A AND THE AMENDMENT OF SECTION 7702

Not long after President Reagan signed the legislation enacting Section 7702, his administration proposed a broad rewrite of the federal income tax law, one element of which was to impose current taxation of the inside build-up. The life insurance industry withstood this assault, and a major reason was the then recent enactment of Section 7702. However, the legislation that resulted from the Reagan Administration's proposal, the Tax Reform Act of 1986, closed down many tax-favored investments as well as outright tax shelters, and this incidentally increased the attractiveness of single premium life insurance for those seeking income tax deferral and the ability to draw on contract cash values via loans without adverse tax consequences (if the contract remained in force until the insured's death). Some very aggressive advertising promoting single premium life insurance contracts as "the last great tax shelter" caught the attention of Congress, as did gimmickry involving mortality and expense charges deployed to dilute the impact of the Section 7702 limits on the investment orientation of such contracts. As had been the case before with life insurance and with other financial instruments, such "poster children" prompted Congress to act, and not so graciously. Here, as elsewhere, Pogo's observation may apply: "we have met the enemy, and he is us."

Specifically, in the Technical and Miscellaneous Revenue Act of 1988, Congress enacted the MEC rules enshrined in Section 7702A and also amended the provisions of Section 7702 that made use of a contract's specified mortality and expense charges in calculating the CVAT and guideline premium limits. By means of the MEC rules, to defeat the use of life insurance as the tax shelter of choice, Congress substantially altered the tax treatment of pre-death distributions from contracts considered to be funded at so rapid a rate that they provided significant tax-deferred inside build-up. Accordingly, a Section 7702-compliant contract entered into on or after June 20, 1988—the date, by the way, that the Ways and Means Committee agreed to the legislation—and that fails a so-called 7-pay test detailed in Section 7702A is characterized as a MEC. Further, pre-death distributions from a MEC are taxed on an income-first basis (that is, the gain in the contract's inside build-up is deemed to be distributed before any recovery of the investment in the contract); loans taken under or against the MEC are treated as distributions, and in many circumstances a 10 percent penalty tax is imposed on the income otherwise subject to tax.[10] This resulted in the tax treatment of the contract being "turned upside down" from the treatment of a life insurance contract that is not a MEC, as to which distributions are viewed as coming from investment first, loans are considered loans, and no penalty tax is to be found. Happily, for both the MEC and the non-MEC, the cash value build-up itself remains untaxed while inside the contract, and the death benefit may be paid to the beneficiary free of income tax.

Rather than taking the step of dividing the world of Section 7702-compliant life insurance into MECs and non-MECs, Congress could have dispensed with the 7-pay test and its numerous complexities and simply applied the MEC rules to

all life insurance contracts. This was in fact considered, with two members of the Ways and Means Committee who were prominent in the development of Section 7702, Rep. Pete Stark (D-CA) and Rep. Bill Gradison (R-OH), introducing legislation in 1987 to do just that. Many in the life insurance industry found this objectionable, for it would impair the tax treatment of what was referred to as "garden variety" life insurance for everyone solely because some had used the single premium product for tax-favored investment purposes. Hence, it may be said that a principal reason Section 7702A exists is to protect the garden variety product from the more adverse tax treatment visited upon MECs.

Even so, Section 7702A is a difficult statute to interpret and administer, as actuaries and others who work with it will attest. Unlike Section 7702, it was developed in an atmosphere of some hostility between congressional tax-writers and the life insurance industry. But, one may ask, why a 7-pay test? Why is the minimum not 5 premiums, or perhaps as high as 20 premiums? The number 7, being a figure classically denoting completeness or perfection, has played a role in history generally—the 7 wonders of the world (ancient and modern), the 7 articles of the U.S. Constitution, the 7 voyages of Sinbad—and in insurance tax history as well, such as in the 4 of 7 premium test embedded in Section 264. Yet in the case of Section 7702A, nothing quite so romantic was at play. The use of 7 in this instance was a matter of political compromise, for Ways and Means Chairman Rostenkowski had proposed a 20-pay test, the life insurance industry expressed preference for a 5-pay test, and the Ways and Means Committee voted to go with 7.

Beyond enacting the MEC rules, the 1988 legislation made substantial changes affecting Section 7702, as noted above. Section 7702 (and based on it, Section 7702A) operates by use of actuarially computed limits, and the legislation amended Section 7702 to require that for contracts entered into on or after Oct. 21, 1988 – the date the House-Senate Conference Committee made its decision on the subject—only "reasonable" mortality and expense charge assumptions may be used in calculating the limits. As originally enacted, Section 7702 had allowed the use of mortality and expense charges specified in a contract, on the theory that market forces would produce charges that were reasonable in amount. Unfortunately, this theory failed in some of the more investment-oriented sales. Rather, in several cases it was discovered that the mortality charges "specified" in the contract aligned, more or less, with what one would charge based on the 1792 Northampton mortality table, even though the charge actually imposed for the cost of insurance under the contract was no more than the going rate in 1988. Congress was not amused, and proceeded to impose reasonableness requirements on the Section 7702 (and 7702A) charge assumptions, spawning a parade of IRS Notices on reasonable mortality charges and much head-scratching on the meaning of reasonable expenses. While this aspect of the 1988 legislation may be viewed as protecting, once again, the inside build-up from current taxation and preserving the historic tax treatment of pre-death distributions for garden variety life insurance, the reader might again refer to Pogo's observation, above.

## A CONCLUDING RECOMMENDATION

The foregoing is but an abbreviated account of the birth of, and rationales for, Sections 7702 and 7702A as they exist today. Some may chafe at the application of the two statutes and even rail against them (the author often does as to the latter one), but the reasons they exist and the protections they provide are undeniable. If the reader now has an interest in following the prompting of the Library of Congress to "read more about it," recourse may be had to chapters 1, 8, and 9 of the second edition of *Life Insurance & Modified Endowments*, the Society of Actuaries textbook on Sections 7702 and 7702A, from which this writing has liberally drawn. ■

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**ENDNOTES**

1 References to "Section" are to sections of the Internal Revenue Code of 1986, as amended (the Code).

2 PLR 8116073 (Jan. 23, 1981); PLR 8121074 (Feb. 26, 1981) (clarifying PLR 8116073).

3 Some refer to section 7702 as the DEFRA rule, since it was enacted by the Deficit Reduction Act of 1984.

4 Some refer to section 7702A as the TAMRA rule, since it was enacted by the Technical and Miscellaneous Revenue Act of 1988.

5 This tax-free treatment is provided via section 101(a)(1).

6 It may be noted that the very first draft of section 7702 that became public in the fall of 1983 did not embody a single premium design, but rather one calling for premiums to be paid over a minimum number of years. In the mark-up of the proposed statute by the Ways and Means Committee, this was changed to the single premium design. In retrospect, this decision was a fortunate turn in events for the functionality of the life insurance definition, as it avoided all the complexity in interpreting and administering a multi-premium test that came to exist under section 7702A. But the decision also set the stage for the marketing abuse of certain life insurance products that led to section 7702A's enactment.

7 *See* Section 7702(a)(1) and (b).

8 *See* Section 7702(a)(2), (c), and (d).

9 This is approximately the rule in Section 7702(g), although the details can be somewhat devilish.

10 This treatment is found in Section 72(e) and (v).