Session 52 PD, Taxation for Beginners

Moderator:

Jeffrey Thomas Stabach, FSA, MAAA

Presenters:

Stephen Baker

Jeffrey Thomas Stabach, FSA, MAAA

2017 Life & Annuity Symposium

Taxation for Beginners

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SOCIETY OF ACTUARIES

Presenters

Stephen Baker, Vice President

Symetra Life Insurance Company

Jeff Stabach, FSA

Ernst & Young LLP

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Overview

- Company tax overview
  - Topics other than reserves
- Product tax overview
  - Annuity products
  - Life insurance products
  - Variable products
- Questions

Company tax overview

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Definition of a life insurance company

- Internal Revenue Code (IRC) §816(a) defines a "life insurance company":
  - Are insurance companies: more than half of the business during a taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.
  - Engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance) or non-cancellable contracts of health and accident insurance
  - Have reserves, more than 50% of which are composed of life insurance reserves (defined below) and unearned premiums, and unpaid losses (whether or not ascertained), on non-cancellable life, accident or health policies not included in life insurance reserves

Definition of life insurance reserves

- IRC §816(b) defines "life insurance reserves" as those amounts that are:
  - Computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest
  - Set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims [see note below]
  - Required by law

Note: Claims must related to life insurance, annuity, and non-cancellable accident and health insurance contracts (including life insurance or annuity contracts combined with non-cancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident or health contingencies.

Classification of life insurance company reserves

Code Section	Reserve Category	NAIC Annual Statement analogue (generally)
§807(c)(1)	Life insurance reserves (§816(b) definition)	Exh. 5 + Exh. 6 NC/GR A&H
§807(c)(2)	Unearned premiums and unpaid losses	Exh. 6 canc. A&H + Exh. 8.1 PVANYD
§807(c)(3)	Discounted amounts under insurance/annuity contracts that do not currently involve life or A&H contingencies	Exh. 7
§807(c)(4)	Dividend accumulations and other amounts held at interest under insurance/annuity contracts	Exh. 7
§807(c)(5)	Advance premiums and premium deposit funds	Exh. 1
§807(c)(6)	Special contingency reserves under group insurance (retired lives of premium stabilization)	Exh. 5 or 6

NC/GR = non-cancellable or guaranteed renewable (tax definition under Treas. Reg. §1.801-3(c) and (d))
PVANYD = present value of amounts not yet due (i.e., claim reserves)

Exclusions from life insurance tax reserves

- The following reserves are NOT taken into account as tax reserves:
  - Deficiency reserves
  - Reserves attributable to deferred and uncollected premiums
  - Reserves for "excess interest" beyond end of taxable year
  - Solvency reserves (such as for asset adequacy testing)
  - Any reserves not required by law
  - Conditional Tail Expectation (CTE) excess under Actuarial Guideline (AG) 43
- Other reserves likely NOT taken into account
  - Deterministic reserve excess under AG 38-8D

Deductible life insurance reserves

- A life insurance company must generally deduct its increase in federally prescribed tax reserves when computing taxable income. See IRC §807(b).
- A life insurance company must generally increase its taxable income for a decrease in tax reserves. See IRC §807(a).
- IRC §807(d)(1) defines a "Federally prescribed reserve" (FPR), as the greater of the (d)(2) method (see below) and the net surrender value or NSV.

Federally prescribed reserves

- IRC §807(d)(2) provides the definition of the FPR as:

  "The amount of the reserve determined under this paragraph with respect to any contract shall be determined by using –

  (A) the tax reserve method applicable to such contract,

  (B) the greater of –

  (i) the applicable Federal interest rate [AFIR], or

  (ii) the prevailing State assumed interest rate [PSAIR], and

  (C) the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account."

Federally prescribed reserves — method

Product	Tax reserve method
Life insurance	CRVM (if covered by CRVM)
Annuities	CARVM (if covered by CARVM)
NC/GR A&H	2-year preliminary term
Qualified long-term care under §7702B, issued in 1998 or later	1-year preliminary term
Other contracts (i.e., not covered by CRVM or CARVM)	NAIC-prescribed method, or if none, a method consistent with CRVM/CARVM

- Methods shown in the table are defined under IRC §807(d)(3).
- CRVM = Commissioners' reserve valuation method
- CARVM = Commissioners' annuity reserve valuation method
- Use the method "prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract"

Federally prescribed reserves — interest

- The general rule under IRC §807(d)(2)(B) requires the use of the greater of AFIR or PSAIR.
  - IRC §807(d)(4)(A)(ii) allows the taxpayer to recompute the AFIR every 5 years. This must be made at the entity level and is revocable only with IRS consent
- Exceptions
  - "Modified guaranteed contracts" (MGCs) under §817A must use constant maturity Treasury rate
  - §807(c)(3) reserves must use the guaranteed rate, if higher
- Common pitfalls
  - Using AFIR straight out
  - Comparing to own state rate, rather than to maximum prevailing rate
  - Using state permitted practices to determine plan type or other
  - parameters for annuity interest rates
  - Discount rate vs. accumulation rate

Federally prescribed reserves — mortality

- IRC §807(d)(5)(B) allows insurers to use old tables when mortality tables change, i.e., a three-year transition
  - Example: 2001 Commissioner's Standard Ordinary (CSO) became prevailing in 2004
  - Optional for contracts issued in 2004, plus 2005-2007
  - Required for contracts issued in 2008 (different from stat)
- Mortality improvement not allowed unless required under the table (94 Group Annuity Reserving (GAR), 2012 Individual Annuity Reserving (IAR))
- Treas. Reg. §1.807-1 — mortality or morbidity table to use if none is prevailing
- IRC §807(d)(5)(E) requires that where two or more tables or table options apply to a category of risks, use table or option that "generally" yields the lowest reserves

Federally prescribed reserves — mortality

Year become prevailing	Life	Individual annuity	Group annuity
1948	CSO 41	SA 37	SA 37
1960	CSO 58 (3-year setback)		
1962		A 49	GA 51
1974		IA 71	GA 71
1979	CSO 58 (6-year setback)		
1982	CSO 80 (smoker-composite)		
1985		83 “a”	83 GAM
1986	CSO 80 (smoker-distinct; optional)		
1999		Annuity 2000	94 GAR
2004	2001 CSO		
2015		2012 IAR	
2017	2017 CSO		

Sources and abbreviations: Rev. Ruls. 92-19 and 2001-38, NAIC Model Reg. 821

Deductible life insurance reserves — floor

- The NSV floor comparison is *generally* applied on a contract-by-contract basis, and aggregating all riders and benefits associated with each contract

Life insurance contract with a supplemental benefit	
Given: Base contract FPR = 95 NSV = 100	Supplemental benefit FPR = 7 NSV = 0
Default approach: apply floor in aggregate for the contract	
Aggregate FPR = 102 Aggregate NSV = 100	→ Final deductible reserve (before cap) = MAX (102, 100) = **102**
"Separate contract" treatment: if qualified supp. ben. (QSB) under §807(e)(3)	
Base deductible reserve = MAX (95, 100) = 100	Supplemental benefit reserve = MAX (7, 0) = 7
→ Final deductible reserve (before cap) = 100 + 7 = **107**	

- Generally no market-value adjustments — except MGCs under §817A

Deductible life insurance reserves — STAT Cap

- IRC §807(d)(1) does not allow the amount of deductible reserves to exceed the amount which would taken into account with respect to such contract as of such time in determining “statutory reserves.”
- IRC §807(d)(6) defines “statutory reserves” as the aggregate amount set forth in the annual statement with respect to items described in IRC §807(c) [see table above] excluding reserves attributable to deferred and uncollected premiums.
- Amounts included in the statutory cap
  - Deficiency reserves (see Notice 2013-19)
  - CTE Excess under AG 43 ?
  - AG 38 Excesses ?

Change in basis for computing reserves

- IRC §807(f) provides that changes in §807(c) reserves are classified as either "changes in basis" or "corrections of errors."
- Corrections of errors are taken into account in the year corrected.
- Changes in basis require that the difference between the reserves computed under the old and new method be spread across 10 tax years.
- Guidance on the definitions has come from a variety of sources:
    - Revenue Ruling 94-74, 1994-2 CB 157
    - Revenue Ruling 2002-6, 2002-6 IRB 460
    - Chief Counsel Advice 200504030
    - Field Service Advice 1998-258
    - Coordinated Issue Paper (Life Insurance: IRC Section 807 Basis Adjustment), 1/6/1997

Change in basis for computing reserves

- Several types of change have been discussed in the guidance. The list below is likely to be treated as a change in basis:

  - (a) a prescribed reserve method;
  - (b) the applicable federal interest rate;
  - (c) the prevailing state assumed interest rate;
  - (d) IRS' prevailing standard table
  - (e) assumptions about when premiums are paid
  - (f) assumptions about when claims are paid
  - (g) assumptions about the age or gender of the insured

IRC §807(f) — example of 10-year spread

At year-end	2016	2017	2018	2019	2020
"Old basis"	90	100	107	110	114
"New basis"	101	108	112	113	114
		Change in basis to spread = 108 – 100 = 8			
		Amount per year = 8 ÷ 10 = 0.8			

Tax Return	Schedule F		Deduction for year's increase in reserves	Deduction for §807(f) spread of strengthening	
	Opening	Closing			
2017	90	100	10	-	
2018	108	112	4	0.8	
2019	112	113	1	0.8	
2020	113	114	1	0.8	
…					
2027				0.8	
2028				---	

Nonlife reserves

- In general, nonlife reserves of a life insurance company are taxed differently from life reserves:
  - An unearned premium reserve is maintained for tax purposes, as for statutory purposes, but is subject to a 20% haircut
  - Unpaid losses are reported on a discounted basis, using prescribed discount rate and payment patterns
  - No reserve deducted until loss event occurs (no catastrophe reserves)
  - Special rules for some lines of business: title insurance, mortgage guaranty

Topics other than reserves

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Proration and the "Company's Share"

- IRC §243 provides as a general rule that most corporations are entitled to a dividends received deduction (DRD) equal to 70% of dividends received from domestic corporations.
- The proration concept provides that because every dollar of life insurance investment income is credited to the policyholder reserves which are in turn deductible, the insurer should be required to reduce its deductions to prevent a double benefit. (This can be compared to IRC §265 eliminating deductions related to the generation of tax exempt income)
- Proration is applied separately to the general and separate accounts

Proration and the “Company’s Share”

- The life insurance company is thus limited to its share of the DRD and tax-exempt income.
- Proration is effectuated through deduction disallowances
  - DRD is allowed only for the company’s share of dividends
  - Reserves are reduced by the policyholder’s share of tax-exempt income

Proration and the "company's share"

- The formula is complex; however, a simple concept should be maintained: how much of the company's net investment income is required to satisfy obligations to policyholders?
- Company share = company's share of net investment income divided by net investment income
- Company's share of net investment income = net investment income less policy interest
  - Net investment income = 90% of general account gross investment income and 95% of separate account gross investment income
  - Policyholder interest = required interest at the greater of PSAIR or AFIR

Proration and the “company’s share”

- The industry understanding of current law has been relatively consistent.
  - A one-time IRS controversy was resolved in 2014
- The DRD has been a subject of discussion for legislative or administrative adjustment for some time
  - The Camp Discussion Draft proposed replacing the existing regime with an approach based upon the ratio of surplus to total assets
  - The Obama Administration FY 2016 Revenue Proposal was similar
  - Congress and the Trump Administration are considering the issue

Capitalized policy acquisition costs ("Tax DAC")

- IRC §848 requires insurance companies to capitalize specified policy acquisition costs/expenses.
- Tax Deferred Acquisition Costs (DAC) (the capitalized amounts) are amortized on a straight-line basis over 120 months beginning with the first month of the second half of the tax year.
- Policy acquisition costs are deemed to be a specified percentage of net premiums in each category of specified insurance contracts:
  - Annuity contracts 1.75%
  - Group life insurance contracts 2.05%
  - Other contracts (i.e., indiv. life, ind./group NC/GR A&H) 7.70%
- Policy acquisition expenses are not tied to either expected profits or actual experience on underlying contracts. This is significantly different from both STAT and GAAP book accounting concepts.

Tax DAC example

- In 2017, Company A received premiums per the table below (no reinsurance).
- Capitalization for Company A:

Contract	Premiums	Capitalization %	Tax DAC
Annuity	400,000,000	1.75%	7,000,000
Group Life	38,000,000	2.05%	779,000
Individual Life	133,000,000	7.70%	10,241,000
Total	**571,000,000**		**18,020,000**

- Amortization for Company A:

Tax Year	Amortization	Expense	
2017	5%	901,000	
2018-2026	10%	1,802,000	per year
2027	5%	901,000	
Total	**100%**	**18,020,000**	

Investments and hedging

- Stock markets experienced significant fluctuation 2008-2010 and (again now have significant movement)
- The movements created large hedge gains and large losses for some VA, writers so companies implemented various methods of recognizing hedge gains and losses.
- This created the need for Industry Issue Resolution (IIR)
- In response to the need, **"I.R.C. §446: LB&I Directive Related to Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies"** was issued by LB&I commissioner in July 2014

Investments and hedging

- The Directive provides a "safe harbor" method of accounting for recognition of the portion of Eligible GMxB Hedge income, deductions, gains and losses allocable to VA contracts issued before December 31, 2009
  - Net hedge gain recognized to the extent of the net tax deduction for the year relating to the VA contracts issued before December 31, 2009
  - Net hedge loss up to the increase for the taxable year in aggregate tax reserves for GMxB under VA contracts issued before December 31, 2009, is not recognized and is carried forward and taken into account in the succeeding year
  - Any hedge gain/loss not taken into account within the five years following the year in which incurred is recognized no slower than ratably over the succeeding five years

Investments and hedging

- Post December 31, 2009 contracts and hedges
  - Directive says to use method "consistent with the matching requirements in Treas. Reg. § 1.446-4(e)(1)"
  - Use method under Directive?
  - Continue to use method pre-Directive?
  - New method to be consistent with Treas. Reg. § 1.446-4(e)(1)?
- GMxB tax reserves to use for purposes of Directive
- Allocation of pre/post December 31, 2009 contracts
- MTM values reported in the Company's Annual Statement
- Implementation and certification

Treatment of life insurance losses

- IRC §810 "operating loss deductions"
- May be carried back 3 years and then forward 15 years to offset taxable income (mandatory utilization schedule)
- Analogue to nonlife insurance "net operating losses," which are carried back 2 years and forward 20 years
- May make irrevocable election to forgo the carryback of losses from a tax year
- IRC §1212: Capital losses may be carried back 3 years and then forward 5 years to offset capital gain (mandatory utilization schedule)

Life-nonlife consolidation

- Treasury Regulation §1.1502-47 is primary guidance.
- Life insurance company must wait 5 years before joining a life-nonlife consolidated group. This may be accelerated by "tacking" onto an existing member. [This is beyond the scope of this presentation]
- Life insurance operating loss deductions may be used 100% to offset nonlife insurance or non-insurance income.
- Nonlife losses are limited to the lesser of 35% of those losses or 35% of the life income to be offset.

Reinsurance

- Basics of accounting
  - Ceding party — reduces premium income, reduces reserves
  - Assuming party — increases premium income, increases reserves
  - Accrual accounting — due premiums for reinsurance may be legally collectible and therefore meet the "all events" test to be treated as premium income and have a corresponding reserve deduction, unlike direct due premiums
- Reinsurance of inforce blocks
  - Ceding commissions and capitalization
    - §848 DAC applies if the underlying contracts are "specified insurance contracts"
    - Assumption reinsurance can also lead to §197 amortization of the ceding commission — related to acquisition of intangibles
    - Courts have held that even indemnity reinsurance of non-DAC-able products can require capitalization of negative ceding commission

Reinsurance

- Reserves
  - What is the issue date?
  - How do you apply the net surrender value floor?
- Tax DAC
  - All reinsurance cash flows affect DAC — premiums, death claims, ceding commissions, allowances, experience rating adjustments, etc.
    - Mod-co and funds withheld — if the money doesn't move, it's not a "net reinsurance consideration"
  - Goal is keeping the books of the world in balance — party with negative net reinsurance considerations can't take a greater DAC benefit than what the party with positive net considerations capitalizes

Reinsurance

- Is it insurance?
  - Risk distribution and risk shifting, fortuity, business drivers other than tax
- IRC §482: Reinsurance between two related parties
  - Parties must demonstrate that the transactions are conducted at an arm's-length standard [transfer pricing].
- IRC §845(a): Reinsurance between two related parties
  - Treasury can reallocate income and deduction items between such parties or recharacterize any such items to "reflect the proper amount, source, or character of such income or deduction of each party"
  - Much higher standard than IRC §482, rarely used but available to IRS
- IRC §845(b): Reinsurance between unrelated parties
  - Same as above, except that Treasury has no obligation to make correlative adjustments to the other party, in the case of a "significant tax avoidance effect" [higher standard than for 845(a)]

Foreign life insurance reserves

- Foreign entities
  - Branch — part of U.S. legal entity
  - Controlled foreign corporation (CFC)
  - §953(d) company — CFC elected to be treated as domestic company
  - Qualified insurance branch
- Subpart F Income
  - Insurance income (§953) plus foreign base company income (§954)
  - Branches can use local country statutory reserves if they meet the "qualified foreign contract" requirements under §807(e)(4)
  - Reserves for insurance income for CFC follow §954(i)
    - U.S. methods apply, with local country interest and mortality, or
    - Local country statutory reserves, if ruling granted by IRS; however, IRS staffing issues may preclude timely resolution.

Financial statements — surplus

- Statutory accounting provides for treatment of timing differences between STAT and Tax. See SSAP 101.
- These differences are either a deferred tax asset (a greater deduction in the future for tax than book) or deferred tax liability (a smaller deduction for tax than book in the future).
- SSAP 101, Paragraph 11 allows for a computed portion of the deferred tax assets to be included in surplus.
- Some of the more significant deferred tax items relate to life insurance reserves, DAC and investments.
- SSAP 101 is beyond the realm of this discussion but should be discussed with tax as reserves or large items are established or changed.

Product tax overview

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Applicable law and sources of information

- Provisions of the Internal Revenue Code (IRC) related to life insurance and annuity products

- Primary source of rules is statutory
  - Annuities: IRC Code Sections 72, 401, 403
  - Life Insurance: IRC Code Sections 72, 101, 7702 & 7702A

- Other authorities that could influence definitions:
  - State law, certain statutory provisions
  - Legislative history
  - Case law
  - IRS pronouncements — Regulations, revenue rulings, revenue procedures, notices & letter rulings

Annuity products

Definition of "annuity"

- No comprehensive statutory definition
- Defining characteristics can be discerned from:
  - Treasury regulations
  - Case law
  - Certain statutory provisions (e.g., Statement of Statutory Accounting Principles 50)
- Qualified vs. non-qualified

Section 72(s) for non-qualified annuities

- Requires certain distributions after death
  - A contract issued after 1/18/1985 must satisfy Section 72(s) by its terms
- Death after annuitization:
  - “At least as rapidly” rule
- Death before annuitization:
  - Entire value must be distributed within five years of death (“5-year” rule)
  - Or over life of designated beneficiary, with payments beginning within one year of holder’s death (“Life expectancy” rule)
  - Special rule for spousal designated beneficiary

Tax treatment of withdrawals and loans

Non-qualified annuities

- Section 72(e) — non-annuity payments
  - Interest/earnings credited to a policy's cash surrender value ("inside build-up") are not includible in taxable income until distributed
    - Inside build-up distributed first
    - Loans are distributions
    - A penalty tax may apply

Treatment of annuity payments

Non-qualified annuities

- Section 72(b) — exclusion ratio
  - Applies to immediate annuities or deferred annuities that have been annuitized
  - Investment in the contract is allowed to be ratably recovered with each payment
  - Ratio is the investment in the contract divided by the expected return
    - Ratio x payments are those excludable from gross income
- Example: Immediate annuity purchased for $13,000 and pays $100 per month, with expected return of $20,000
  - Ratio = 65% (13,000 / 20,000)
  - Amount excludable from gross income = $780 (65% *100*12)
  - Remainder is included in gross income = $420 (1,200 - 780)

Qualified annuities

- Definition
- All payments are generally taxed as ordinary income
- Examples include:
  - IRA's (Traditional, Simplified Employee Pension (SEP), Savings Incentive Match Plan for Employees (SIMPLE), Roth)
  - 403(b) annuities
  - 401(a) qualified plans
  - 403(a) qualified annuities
  - Deferred compensation plans
- Required Minimum Distributions (RMDs)

RMDs
Qualified annuities

- Rules generally apply to all types of qualified plans
- Distributions must commence by the “required beginning date”
  - April 1 of the calendar year following the later of the year in which owner attains age 70 ½ or retires
- “Entire interest” will be distributed:
  - No later than the required beginning date, or
  - Over the life/life expectancy of the owner, or
  - Over the joint lives/ life expectancy of owner and “designated beneficiary”
- “At least as rapidly, ” “5-year,” and “Life expectancy” rules apply

Life insurance products

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Life insurance tax treatment

- Death benefits paid to the beneficiary generally are tax free
- Increments in the cash surrender value are not includible in the taxable income of the policy owner
  - Inside build-up = interest and gains earned inside a life insurance policy
  - Not taxed until surrender

Requirements for life insurance qualification

- In order to receive these tax benefits, a life insurance contract must:
  - Be life insurance under “applicable law”
  - Meets one of two actuarial tests
    - Cash value accumulation test (CVAT)
    - Guideline premium & cash value corridor test (GPT)
- Actuarial tests regulate the relationship of the premium, death benefit and cash value

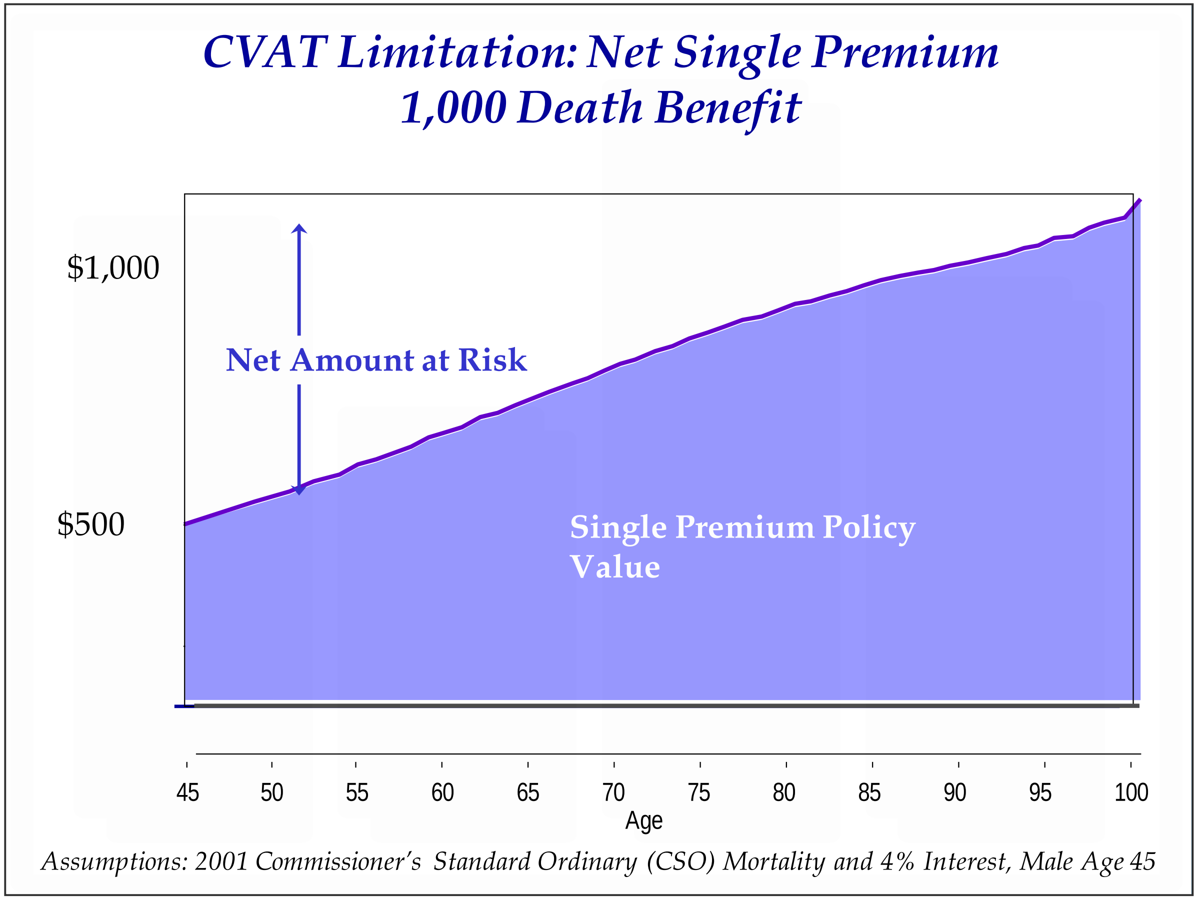
Cash value accumulation test

- By the terms of the contract, the cash surrender value cannot exceed the net single premium required to fund future benefits under the contract
- Key terms:
  - Net single premium
  - Cash surrender value
  - “Terms of the contract”

Cash surrender value

- To meet the CVAT, the contract must be structured so that, at each point in time, the cash surrender value can never (under any possible scenario) exceed the net single premium.
- “The cash surrender value of any contract shall be its cash value determined *without regard* to any surrender charge, policy loan, or reasonable termination dividends”

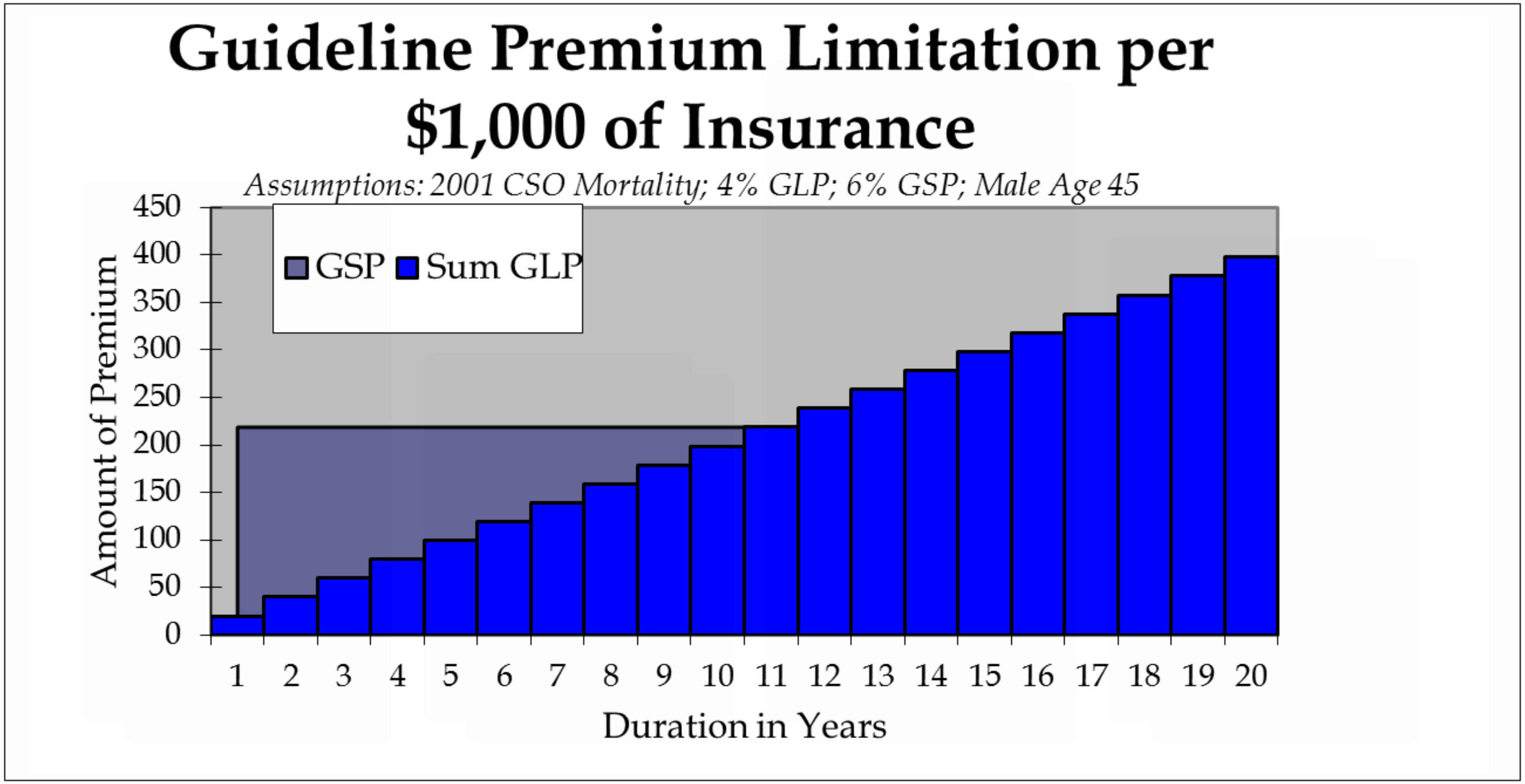
Sample CVAT imitation



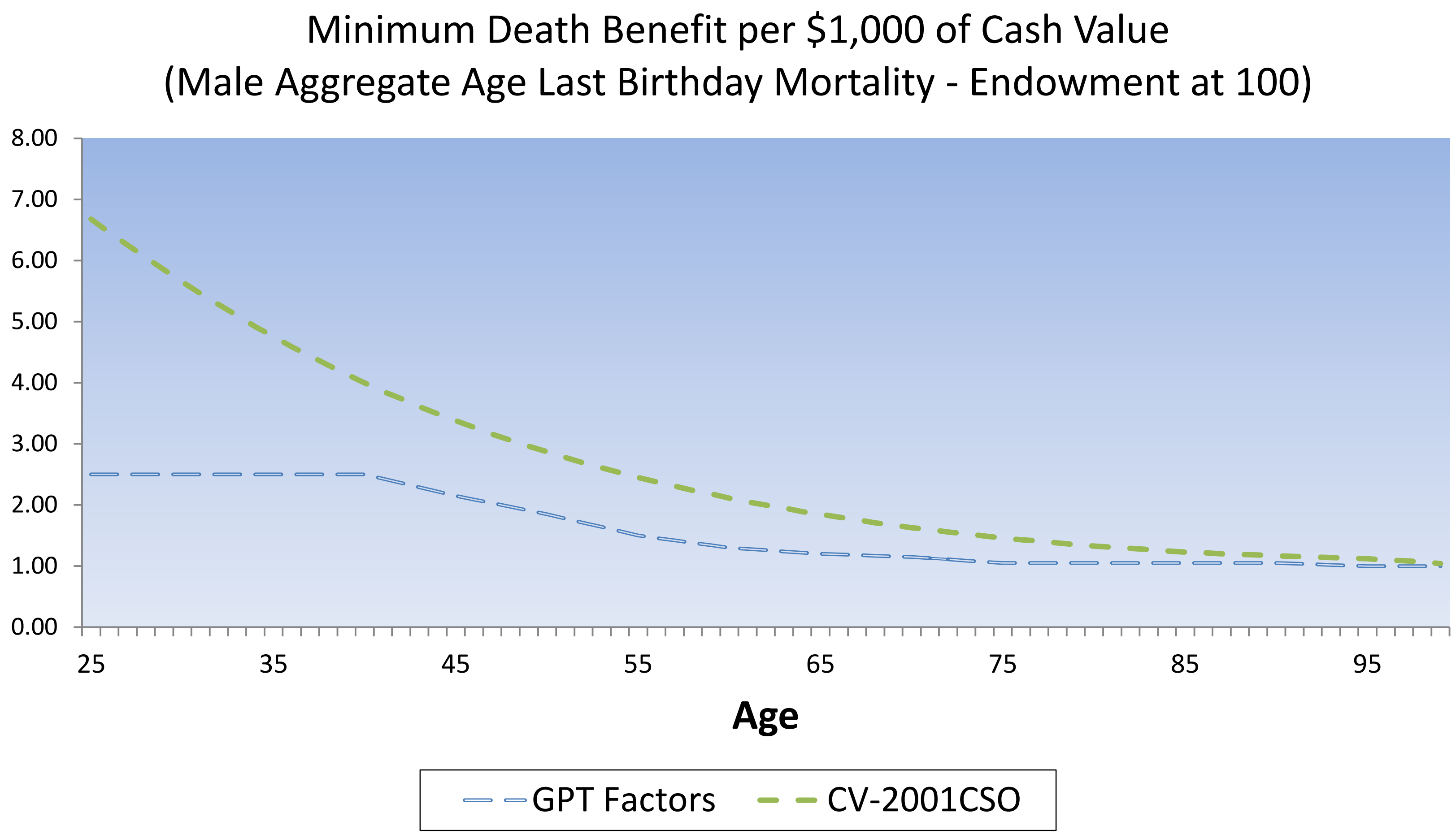
Guideline premium test

- Dual-element test
  - Gross premiums paid under the contract do not exceed the guideline premium limitation
  - Statutory cash value “corridor” requirement is satisfied (IRC 7702(d))
- Guideline premium limitation = greater of:
  - The guideline single premium (GSP)
  - Sum of the guideline level premiums (GLP) to date

Sample guideline premium limitation



Comparison of GPT to CVAT



Additional considerations

- Actuarial assumptions
  - Restrictions on actuarial assumptions are a key element in developing the definitional limitations
    - Mortality
    - Interest
    - Expense charges
    - Rider charges
  - Contract provisions and guarantees form the basis of the actuarial assumptions
  - Important to recognize that requirements vary based on contract issue date
- Computational rules
  - Limit the timing and pattern of future benefits that may be assumed
    - Death benefits generally assumed not to increase and deemed to the maturity date

Modified endowment contracts

- Defined in section 7702A(a)
- Entered into on or after June 21, 1988
- Life insurance contract within the meaning of section 7702
- Fails to meet the 7-pay test prescribed in section 7702A(b)
  - Received in exchange for a modified endowment contract
- Consequence of being a Modified Endowment Contract (MEC)
  - Applies annuity tax treatment (income first rules apply) to pre-death distributions, including:
    - Withdrawals / partial surrenders
    - Policyholder dividends, unless retained by the insurer as premiums under the same contract
    - Policy loans (including capitalization of loan interest)
    - Assignments
  - Possibly 10% penalty tax under section 72(q)

Seven pay test

- First year after issue:
  - Contract will fail the 7-pay test if the accumulated amount paid under the contract, at any time during that contract year, exceeds the 7-pay premium
- Second through seventh contract years:
  - Accumulated amounts paid under the contract are compared to the sum of the 7-pay premiums accrued to date

Policy adjustments

- Adjustment events under section 7702
  - Guideline premiums are adjusted based on an attained-age adjustment methodology
- Policy changes under section 7702A
  - Differing rules based on type of change
    - Material change events
      - Contract is treated as newly issued on date of change
    - Reduction in benefits
      - Retroactive testing assuming contract is reissued with reduced benefits
      - Generally applied in first 7 contract years
- Effective dates and loss of grandfathering

Variable products

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Variable contracts

- Diversification rules
  - Apply to non-qualified variable annuities (and variable life insurance)
  - Each "segregated asset account" must be "adequately diversified" according to specific rules
- Investor control doctrine
  - Contract owner must not be viewed as controlling the underlying assets
  - Indicators of control include
    - Actual control over asset acquisition, disposition and management
    - Use of publicly available pools of assets

Product tax non-compliance

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Consequences of non-compliance

- Failure to satisfy the qualification requirements imposed by the IRC can have various impacts to insurers, including:
  - Reputational risk & policyholder dissatisfaction
    - Potential claims, lawsuits by policyholders
    - Damage to brand name and agent relations
  - Disclosure to auditor
  - Company tax implications

Consequences of non-compliance, continued

- Failure to satisfy the qualification requirements imposed by the IRC can have various impacts to the taxation of products, including:
  - Non-qualified annuities – Section 72(s)
    - Earnings currently taxable, although no published guidance for:
      - Issuers to correct
      - Calculation of income
  - Qualified annuities – RMD rules
    - 50% excise tax applies
    - Possible plan disqualification
  - Life insurance – Section 7702/7702A
    - Exposes insurer's to tax reporting errors and penalties
      - Qualification status sets forth reporting requirements
        - Differs for a section 7702 compliant and failed contract
        - Differs for MECs and non-MECs
    - Cost of remediation (contracts and systems) can be substantial
  - Variable contracts – Diversification and investor control
    - Owner currently taxable on earning under entire contract
    - Withholding and reporting requirements for issuer

Remediation of qualification failures

- Annuities
  - No “standard” closing agreement process
- Life insurance
  - Revenue Procedure 2008-39
    - Closing agreement to “un-MEC” an inadvertent MEC
  - Revenue Procedure 2008-40
    - Closing agreement to remediate failed contracts
- Variable contracts
  - Revenue Procedure 2008-41
    - Closing agreement to remediate diversification failure

Questions?

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