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Evolution of the Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code

Christian DesRochers

Notice 2004-61[1] is the latest in a series of administrative pronouncements from the Internal Revenue Service related to the appropriate mortality assumptions to be used in computing the definitional limitations under Internal Revenue Code Section 7702 and the seven-pay limitation under the Section 7702A modified endowment rules. Specifically, Notice 2004-61 deals with the transition from the 1980 Commissioners' Standard Ordinary Table (1980 CSO) to the 2001 Commissioners' Standard Ordinary Table (2001 CSO) in determining whether mortality charges are reasonable as defined in Section 7702(c)(3)(B)(i). The notice clarifies the effective date requirements of the 2001 CSO, but also provides some additional guidance on issues related to the 1980 CSO. The requirements of the notice can best be appreciated in the context of the evolution of the mortality requirements under Sections 7702 and 7702A, as it represents another installment in the discussion between the life insurance industry and the Internal Revenue Service over mortality issues.

Background

"Reasonable" Mortality

As enacted in 1984, Section 7702 permitted the recognition of contractually guaranteed mortality charges in the calculation of the guideline premium limitation or the net single premium under the cash value accumulation test. In 1988, as a part of the modified endowment legislation, the Congress added a requirement under Section 7702(c)(3)(B)(i) for contracts issued on or after October 21, 1988, limiting the mortality charges that could be reflected in computations under the statute to those that are reasonable.

The mortality requirement consists of two elements: a *permanent rule* and an *interim rule*. The *permanent rule* refers to the specific statutory language in Section 7702(c)(3)(B)(i). While requiring that mortality charges used in section 7702 (and 7702A) be "reasonable," the statute fails to provide any guidance on how reasonability might be determined, instead delegating that task to the IRS through regulations. However, the *permanent rule* imposes a limitation that, absent an exception provided in regulations, reasonable mortality cannot exceed the rates in the prevailing commissioners' standard table at the time the contract is issued.

The concept of the prevailing table was borrowed from the rules in life insurance company taxation governing the deductibility of life

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[1] *2004-4 I.R. B. 596, (October 12, 2004).*

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FROM THE EDITOR

BRIAN G. KING

Welcome readers! It is with great excitement that we introduce the new SOA Tax Section Newsletter. Our goal with this newsletter is to provide a forum for discussing and exchanging knowledge, ideas, updates and issues concerning life insurance taxation.

It is our intent for the newsletter to be published three times a year—January, May and September.

For this first issue, we would like to begin by acknowledging our editorial board members: Peter Winslow, Bruce Schobel and Ernie Achtien. Their commitment to this newsletter has made this first issue a reality. We thank them for their dedication.

Next, let's talk about our membership. Currently, we have 429 members signed up for the SOA Taxation Section. While the majority of our membership is from the United States, we also have a great representation from Canada, as well as a member from Hong Kong and Malaysia. The diversity of our membership also extends into their areas of employment, where we have those who work directly for insurance companies or consulting firms and those who work for organizations servicing the insurance business. A recent survey of our membership shows employment in many areas including: insurance companies, consulting firms, banks, investment houses, software companies, law firms and government agencies. With this diverse membership comes a tremendous amount of knowledge in the area of insurance taxation. We need to capitalize on this expertise—use our knowledge and communicate our message effectively to make this section successful.

For that, we need section members to get involved with section activities. I encourage all our readers to submit questions and comments to the newsletter. This includes comments on content, format, organization, anything at all. In subsequent issues, we will include an "Ask the Editor" section that will respond to your questions and comments. I also encourage you to submit topics that you would like to see addressed in the newsletter, or if you would like to write an article on a tax topic, contact us and we will consider it for publication.

We have a lot of tax knowledge in this section. Let's make the most of it by all getting involved. Enjoy the first issue and I look forward to hearing from you.

Sincerely,
Brian G. King
Editor

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Ask the Editor

Every Issue of Taxing Times will feature an Ask the Editor Column. This is an opportunity for our readers to get involved with our section newsletter. We want your comments, questions, and topics. Please send your emails to *brian_king@aon.com.*

The editorial board looks forward to responding to your questions and concerns. Thank you in advance for your contributions.

FROM THE CHAIR

EDWARD L. ROBBINS

It's exciting participating in the launch of a new section. We have a good mix of members and corresponding non-Society of Actuaries (SOA) members. With the legal, accounting and actuarial professions well represented, we are truly a multidisciplinary group, which means that we are in the position of being able to benefit from each other's area of expertise.

We got off to a running start in early October 2004, when we reached the mandatory threshold of 200 members. (We now number over 400 members.) We have also compiled a list of willing volunteers to help fill out our teams and move our section forward. We can still use more volunteers. If you are interested, please contact Kimber Howard at the SOA office at khoward@soa.org.

If I may wax eloquent for a moment, the Taxation Section was formed to fill a void. For many years the professional tax actuarial role has been played only by a relative handful of actuaries—those who go beyond performing the mechanics of tax reserve valuations, to the research, planning and documentation appropriate to this significant function and integrating it with statutory and GAAP implications. Yet, taxes are the typical life insurance company's largest single expense. Moreover, since tax reserves make up most of a life insurer's tax basis liabilities, it is high time that company taxation became more of a focus for actuaries in general, and of course, for actuarially minded accountants and attorneys. Similarly, the area of life insurance and annuity contract-holder taxation is to a great extent computational and, sad to say, the history of the many errors made in the past in our industry cries out for more serious actuarial attention.

We need to nurture an environment where taxation is a major professional actuarial field and further an attractive career path for a young actuary. Knowledgeable tax actuaries who can work well with attorneys and accountants both inside and outside their organizations can enjoy rewarding careers. It is one of our primary mission objectives to encourage the development of strong leaders in this field.

That said, because of the affiliations of the section organizers, our current orientation is toward life insurance company and product taxation in the United States. This section intends to have a broader reach and we strongly encourage our compatriots in the retirement and other fields, as well as members from outside the United States to join us in bringing their tax education and research needs to the table.

At this time there are two other actuarial tax groups with whom we are working in concert. The American Academy of Actuaries has recently established its Tax Subcommittee, and the American Council of Life Insurers has established its Actuarial Tax Policy Committee. Together we aim to bring our expertise to the table, each of the three groups assuming its respective role. The SOA Taxation Section will serve the role of education, research and tax actuary career guidance.

A word about the projects currently on our plate:

- Our own newsletter will be published three times per year. This first issue published this May, will be followed by issues in September and January.

- An update of basic education materials regarding life insurance company and policyholder taxation will be provided.

- For the SOA Spring 2005 Meeting in New Orleans, we are planning two sessions:
  - A Taxation Section hot breakfast, with a guest speaker
  - A workshop on the current tax reserve audit environment

- For the 2005 Annual Meeting in October, we are planning a session to introduce the new textbook, *U.S. Statutory and Tax Reserves for Life Insurers*.

- Also, this coming fall, we are planning a seminar on life insurance company taxation, so that our members can navigate their way through a Form 1120-L Life Insurance Company tax return.

- In the fall of 2006 we are planning to repeat our highly successful biennial seminar on life insurance and annuity product taxation.

We will soon be rolling out a survey request on the current tax actuarial function in life and health insurance companies.

And, of course, we would like to hear from you, our members and corresponding members, about projects you would like us to take on.

Again, welcome, from myself and the other members of the Taxation Section Council. It's going to be an active ride.

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insurance reserves. Under section 807(d)(5), the prevailing commissioners' standard table is the most recent commissioners' standard table prescribed by the National Association of Insurance Commissioners (NAIC), which is permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued. The rules applicable to life insurance company taxation use the prevailing table to limit the mortality that may be assumed in the computation of deductible life insurance reserves.

At the time the reasonable mortality standards were added to section 7702, the 1980 CSO was the prevailing commissioners' standard table[2]. Therefore, under the *permanent rule*, 100 percent of the sex-distinct 1980 CSO Tables generally provided an upper bound on reasonable mortality. Adopted by the NAIC in December 2002, the 2001 CSO has replaced the 1980 CSO as the most recent standard table prescribed by the NAIC. Subsequently, it became the prevailing table in July 2004 after adoption by 26 states.

Section 5011(c)(1) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) directed the Secretary of the Treasury to issue regulations under Section 7702(c)(3)(B)(i) by January 1, 1990, setting forth standards for determining the reasonableness of assumed mortality charges. In response, proposed regulations were issued in 1991, as discussed below, although the U.S.Treasury Department has yet to issue final regulations. Consequently, the *permanent rule* simply limits assumed mortality charges to the prevailing commissioners' standard tables in effect on the issue date of the contract, at least for standard cases. Thus, under the *permanent rule*, mortality is limited to the 2001 CSO Table, subject to a transition rule to determine the effective date. With the change in the prevailing table, guidance on the transition to the 2001 CSO was needed. As will be discussed below, Notice 2004-61 provided that guidance.

In the 1988 legislation, Congress also provided an *interim rule* for contracts issued on or after October 21, 1988, but before the effective date of final regulations.[3] The *interim rule* states that mortality charges, which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristics of the insured of which the company is aware), shall be treated as meeting the requirements of Section 7702(c)(3)(B)(i). As permanent regulations have yet to be issued, the *interim rule* is the currently operative rule.

Notice 88-128

While sounding rather straightforward conceptually, for those actually responsible for computing the limitations, the *interim rule* created a rather vague standard. For contracts with current and guaranteed mortality charges, there was a concern that the *interim rule* required the recognition of the current charges in computing the limitations. In response to the industry's request for guidance, the U.S. Treasury Department issued Notice 88-128,[4] which applies to contracts issued on or after October 21, 1988. Notice 88-128 previewed rules interpreting the reasonable mortality charge requirements, stating that regulations to be published in the future would contain certain provisions. It also provided assurances to the industry regarding ongoing compliance with Section 7702(c)(3)(B)(i) to companies that satisfied the *interim rules* contained in Notice 88-128.

Notice 88-128 generally allows that the use of sex-distinct, aggregate mortality rates under the 1980 CSO Tables is reasonable. The Notice does not define "reasonable mortality," but instead provides that use of certain safe harbor mortality tables will satisfy the requirements of Section 7702(c)(3)(B)(i). The safe harbor mortality table for contracts entered into after October 20, 1988 is 100 percent of the sex-distinct 1980 CSO Tables (consistent with its specification as the prevailing commissioners' table).

Specifically, Notice 88-128 provides that "a mortality charge meets the requirements of Section 7702(c)(3)(B)(i) if such mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables."[5] It does not, however, address the use of the smoker and nonsmoker versions of the 1980 CSO, nor does it appear to provide a safe harbor for the voluntary use of the unisex versions of the table. It goes on to say that, "to the extent that a state requires … [the use of] unisex tables, thereby imposing, for female insureds, mortality charges that exceed the [sex-distinct] 1980 CSO tables, … [the increased mortality charges] may be taken into account with respect to contracts to which that unisex requirement applies."[6]

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[2] *Rev. Rul. 87-26, 1987-1 C.B. 158, defines the Commissioners' 1980 Standard Ordinary male or female table, as appropriate, without select factors as the prevailing table.*

[3] *Section 5011(c)(2) of TAMRA.*

[4] *Notice 88-128 1988-2 C.B. 540.*

[5] *Ibid.*

[6] *Ibid.*

The safe harbors provided by Notice 88-128 apply to contracts issued on or before 90 days after the issuance of temporary regulations on reasonable mortality (which the IRS has not issued). The Notice also provides that, if the charges specified in the prevailing commissioners' standard tables exceed the allowable charges under the standards set forth in the regulations, the regulations will apply prospectively to the extent of the excess. This is consistent with the TAMRA legislative history indicating that any "[s]tandards set forth in such regulations that limit mortality charges to amounts less than those specified in the prevailing commissioners' standard tables are to be prospective in application."[7]

…the proposed regulations … provide some insight into government thinking on the subject at the time that they were proposed, and appear to have served as the model for the safe harbor requirements of Notice 2004-61.

Proposed Regulation Section 1.7702-1

In 1991, several years after the issuance of Notice 88-128, the IRS issued proposed regulations to define reasonable mortality charges for use in computations under Sections 7702 and 7702A. Unlike Notice 88-128, which provided certain safe harbor mortality tables for satisfying the reasonable mortality requirements, the proposed regulations actually defined reasonable mortality. In the proposed regulations, which never have been finalized, reasonable mortality charges were defined to be "those amounts that an insurance company actually expects to impose as consideration for assuming the risk of the insured's death (regardless of the designation used for those charges), taking into account any relevant characteristics of the insured of which the company is aware."[8]

Like the *permanent rule* contained in Section 7702(c)(3)(B)(i), the proposed regulation also placed an upper bound on what constitutes reasonable mortality. In particular, reasonable mortality charges could not exceed the lesser of the mortality charges specified in the prevailing commissioners' standard tables in effect when the contract was issued or the guaranteed mortality charges specified in the contract. This dual limit on "reasonable" mortality would have prevented the use of the prevailing table for those contracts that explicitly guarantee lower mortality charges. In this respect the limitation in the proposed regulations differs from that in Notice 88-128; the Notice does not limit mortality based on the charges in the contract.

The proposed regulations also describe two safe harbors related to the 1980 CSO, under which mortality charges for contracts with only one insured are deemed to be reasonable, as follows:

(1) The use of mortality charges that do not exceed the applicable charges set forth in the 1980 CSO Mortality Table for male or female insureds are reasonable mortality charges; and,

(2) The use of smoker-distinct and gender-blended rates satisfies the safe harbor requirements, if certain conditions are met.

The proposed regulations permitted far greater leeway than Notice 88-128 for single life contracts, subject to a consistency or "anti-whipsaw" rule. For example, 1980 CSO-based mortality rates are deemed to be reasonable if consistently applied within a class of contracts, whether or not distinctions were made according to the insured's sex or tobacco use. Thus, for example, it would not be reasonable, within the same plan of insurance, to use the 1980 CSO aggregate table for nonsmokers and use the smoker table for smokers. Note that this rule implies, but does not specifically state, that 100 percent male mortality is likely not a valid unisex table.

Although issued in 1991, the proposed regulations would have applied to contracts entered into on or after October 21, 1988. This attempt at retroactivity was of no import, however, as the proposed regulations have not been adopted and thus, do not embody legal requirements. They do, however,

[7] *H.R. CONF. REP. NO. 100-1104. pt. 2, at 108 (1998) (the "TAMRA Conference Report").*

[8] *Prop. Treas. Reg. § 1.7702-1(b).*

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provide some insight into government thinking on the subject at the time that they were proposed, and appear to have served as the model for the safe harbor requirements of Notice 2004-61.

Notice 2004-61

Issued in the fall of 2004 in response to the life insurance industry's request for guidance on the transition to the 2001 CSO, Notice 2004-61 provides rules for the transition to the new table. While specifically providing that "rules described in Notice 88-128 remain in effect, except as modified by this notice," it also provides safe harbors that relate to the 1980 CSO, incorporating some concepts that were found in the proposed mortality regulations.

Safe Harbors

Under the Notice, a mortality charge with respect to a life insurance contract will satisfy the requirements of section 7702(c)(3)(B)(i) so long as:

(1) The mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO tables;

(2) The mortality charge does not exceed the mortality charge specified in the contract at issuance; and

(3) Either the contract is issued after Dec. 31, 2008, or the contract is issued before January 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued.

For a contract issued under the 2001 CSO, the Notice requires the use of the 2001 CSO for contracts issued on or after Jan. 1, 2009, and permits the use of the 2001 CSO until that time in any state that either allows or requires that the 2001 CSO be used. The effective date provisions follow the adoption dates provided by the NAIC in their regulation adopting the 2001 CSO. The NAIC Model Regulation provides that the 2001 CSO Table can be applied at the option of a company until Jan. 1, 2009, by which time all products offered for sale must be 2001 CSO[9] compliant. In following the NAIC Model, the Internal Revenue Service, in effect, adopted the same transition rules for compliance with the definitional limits as the states have provided for contract nonforfeiture values, thus removing any potential conflict between state law and federal tax law requirements.

At the same time, however, the Notice follows the dual mortality limitation of the proposed mortality regulation rather than the single limitation provided for the 1980 CSO under Notice 88-128. Taken at its face, the safe harbor for "reasonable" mortality must recognize the guaranteed mortality charges specified in the contract, in the event they are less than the applicable 2001 CSO charges.

Under the Notice, the 1980 CSO remains the safe harbor for reasonable mortality under the following conditions:

(1) The mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables.

(2) The mortality charge does not exceed the mortality charge specified in the contract at issuance.

(3) The contract is issued in a state that permits or requires the use of the 1980 CSO tables at the time the contract is issued, and the contract is issued before Jan. 1, 2009.

Like the 2001 CSO requirements, the effective date provisions simply follow the NAIC transition rules, allowing the use of the 1980 CSO until Jan. 1, 2009. However, the safe harbor for the 1980 CSO contains the same dual limitation as the requirements for the 2001 CSO (and the proposed regulation). Since this is different from the safe harbor provided in Notice 88-128, which simply limited the charges to "100 percent of the applicable mortality charges set forth in the 1980 CSO tables," it raises the question of whether an additional requirement has been added to the safe harbor for the 1980 CSO. This applies to both the definitional limitations under Section 7702 and the modified endowment rules under Section 7702A.

If so, issues then arise as to the effective date of the new dual limitation. One interpretation is that the dual limitation applies retroactively to the effective date of the reasonable mortality requirements—replacing the limitation currently found in Notice 88-128. Another is that the limitation does not apply to contracts that were issued before the publication of Notice 2004-61.

[9] *Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation (NAIC, December 2002).*

Questions also arise as to the status of contracts that would meet a limitation computed using the 1980 CSO, but not one recognizing the guaranteed mortality charges in the contract. For their part, the IRS effectively served notice on the industry that the dual limitation was their preferred interpretation as it was included in the 1991 proposed regulations, but they would seem to have difficulty in disqualifying contracts issued in reliance on Notice 88-128.

While notice 2004-61 appears to conform the "reasonable" mortality requirements to widespread industry practice, it also reflects an ongoing IRS concern about potential abuse of the mortality standards.

Smoker-Distinct and Gender-Blended Tables
Notice 2004-61 also provides guidance related to the smoker-distinct and gender-blended tables that are a part of the 2001 CSO "family" of tables, as well as to similar variations of the 1980 CSO. Here again, the safe harbor rules apply to follow the approach from the proposed mortality regulations rather than that of Notice 88-128. While Notice 2004-61 appears to conform the "reasonable" mortality requirements to widespread industry practice, it also reflects an ongoing IRS concern about potential abuse of the mortality standards.

The applicable variations of the tables are available as a safe harbor for reasonable mortality provided that,

(1) A state permits minimum nonforfeiture values to be determined under the smoker-distinct or gender-blended variation of the tables, as applicable; and,

(2) The corresponding tables must be used for nonsmoker or male mortality, as applicable.

The requirement that the tables are to be applied consistently follows the "anti-whipsaw" provisions found in the proposed mortality regulations.

Contract Changes
The effective date language in the Notice uses a contract's issue date to determine whether the 1980 CSO or the 2001 CSO applies to contract changes made after the mandatory Jan. 1, 2009 effective date. In describing the "date on which a contract was issued," the Notice refers to the "standards that applied for purposes of the original effective date of Section 7702."[10] As described in the legislative history, the original transition rules followed the principle that "contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange."

While this language would clearly apply to a new 2001 CSO contract that replaces a 1980 CSO contract, it may also sweep in changes made to existing contracts, depending on the nature and the extent of the change. In this regard, the legislative history (and Notice 2004-61) provides that, "for these purposes, a change in an existing contract is not considered a result in an exchange if the terms of the resulting contract (i.e., is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, and mortality and expense charges) are the same as the terms of the contract prior to the change."

Notice 2004-61 goes on to provide examples of exceptions, noting that if a life insurance contract satisfied the 1980 CSO (or 2001 CSO) safe harbor when originally issued, a change from previous tables to the 2001 CSO tables is not required if:

1) The change, modification or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract;

2) The state in which the contract is issued does not require use of the 2001 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and

3) The contract continues upon the same policy form or blank.

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[10] *See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1076 (1984), 1984-3 (Vol. 2) C.B. 330; see also 1 Staff of Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984.*

T³: *Taxing Times* Tidbits

Peter H. Winslow and Susan J. Hotine

Is the IRS Saying that Class Action Damages are not Subject to IRC section 72?

One of the significant tax benefits of a life insurance contract is that, for purposes of determining the taxable amount of proceeds received under the contract on distributions or surrender, the investment in the contract includes the aggregate amount of premiums, unreduced by the cost of insurance provided (IRC section 72(c)). In a recent Chief Counsel advice letter (CCA), the IRS seems to have ignored this basic tax rule and effectively treated a policyholder as taxable on the cost of insurance. However, the adverse result might have been avoided by a little tax planning.

In CCA 200504001 (Oct. 12, 2004), the IRS concludes that damages received from an insurance company in settlement of a class action lawsuit are includible in gross income to the extent that they exceed the policyholder's basis in the life insurance policies. However, rather than use the investment in the contract under section 72 to determine the basis and apply section 1035, the IRS used a section 1001 analysis and determined the basis for this purpose as being the premiums paid, reduced by the cost of insurance provided, as well as by amounts previously received and not included in income. In the CCA, a woman policyholder held two life insurance policies issued by the same insurance company. The first policy, which was on her former husband's life, was converted to a policy with a lower face amount (the company encouraged her to do so by erroneously saying that she would not incur any additional premiums). The second policy, on her own life, was surrendered. A class action suit was brought against the insurance company with claims that the company induced the policyholder to surrender, borrow against or otherwise withdraw values from the policies by misrepresenting the financial effect of such transactions and failing to disclose that such switches were against the policyholder's best interest. As part of the class action settlement, the policyholder was awarded damages, a portion of which was interest. The policyholder in the CCA filed a return, reporting the entire amount of damages as income and later amended her return seeking a refund, arguing that the portion of the damages in excess of interest represented the recovery of out-of-pocket expenses for premiums. The CCA concludes that the damages received by the policyholder with respect to the policy on her former husband's life (the first policy) are not includible in her gross income to the extent they exceed her "basis" in the insurance policy, as defined above. With respect to damages attributed to the policy on her own life (the second policy), the CCA concludes that all amounts are included in the policyholder's gross income because the policy was surrendered.

Ordinarily in these types of cases, the IRS looks to "the origin of the claim doctrine" to determine how the damages should be characterized. Had it done so, presumably it would have determined that the damage claims arose under the contract for life insurance and were paid in lieu of earnings the policyholder would have received under the first and second policies, if those policies had not been converted and surrendered, respectively. Under this analysis, the substitute damage payments received are treated as distributions from the life insurance policies and the IRS should have looked to section 72 and section 1035 for the tax treatment. Because the investment in the contract under section 72(c)(1) is not adjusted for the cost of insurance protection, there should have been no reduction in basis for this amount to determine the taxability of the damages received for the first policy. On the other hand, when the policyholder converted the first policy for the policy of a lower face amount, there was a tax-free exchange of policies covered by section 1035. Under section 1031(d), the basis of the new policy is the same as the first policy. With the receipt of cash damage payments, and having retained the new lower-face-amount policy, the policyholder effectively has "exchanged" the first policy for the new

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policy, plus cash. In such circumstances, gain is recognized on the exchange, but not in excess of the cash plus the fair market value of the new contract (see section 1031(b)). No basis from the first policy is allocable to the cash money received (see section 1031(d)).

In summary, if the origin of the claim is considered a payment in lieu of a distribution under the first policy, section 72 should have governed a good result. On the other hand, if the claim is considered to arise under the exchange, the basis rules of section 1031(d) should have governed a bad result. Under this section 1031(d) analysis, the analysis of the CCA may have been wrong, but it could have been worse.

The CCA cites a case and a revenue ruling as authority for how to determine the policyholder's basis. However, both the case and the ruling involved situations in which the policyholder received money in exchange for the transfer of the policy to a third party, and the amount received was less than the amount of premiums paid so that the basis was being defined for purposes of determining whether the policyholder had suffered a loss. Based on facts provided by the CCA upon the receipt of the damages, the policyholder is in a position of determining her gain on the first policy. One has to wonder if some pertinent facts are missing from the CCA's explanation, if their analysis reveals a misguided IRS plot to adopt a new approach for determining the tax treatment of damages and the amount of gain on a life insurance contract, or if the CCA was issued by a branch of the IRS that is just unfamiliar with section 72 and section 1035.

In damage cases like this, adverse tax consequences might be avoided with a bit of tax planning on behalf of the policyholder by the negotiators of the settlement. If the damages had been paid into the cash value of new lower-face-amount policy (making sure that such payment did not disqualify the contract under section 7702), the damages probably would have been considered as part of the initial tax-free exchange. The damages then could have been withdrawn from the new life insurance policy at some later time under the basis-out-first rule of section 72(e)(5)(C).

The conclusion of the CCA is that the damages received with respect to the second policy are taxable may be correct under both its erroneous analysis, and under a section 72 analysis, if the policyholder already had recovered her entire basis or investment in the contract upon surrendering the second policy. If that is not the case, the policyholder should still have had some basis to recover under section 72, unreduced by the cost of insurance.

In damage cases like this, adverse tax consequences might be avoided with a bit of tax planning on behalf of the policyholder by the negotiators of the settlement.

IRS Rules Net Surrender Value Reserves must be Reduced by a YRT Reserve Credit

In TAM 200435015 (May 11, 2004), the IRS concluded that Treas. Reg. §1.801-4(a) (promulgated under the 1959 Act) has continuing applicability under present law and requires a life insurance company to reduce its life insurance reserves by the net value of the risks reinsured on a yearly renewable term (YRT) basis even if reserves are based on the net surrender value. In arriving at this conclusion, the IRS reversed its position as explained in FSA 200123024 (Mar. 7, 2001). The IRS got it right the first time.

Treas. Reg. §1.801-4(a) provides an example of YRT reinsurance with other solvent companies (whether or not authorized), and provides that life insurance reserves must be reduced for the risks reinsured. The TAM characterized the YRT example in the regulation as requiring that life insurance reserves on a contract must be reduced for a YRT reinsurance credit even if the reserves are based on the net surrender value. In the TAM, the IRS said that the addition of the net surrender value floor to the computation of federally prescribed tax reserves in section 807(d)(1) for a contract does not override the requirement in the regulation that life insurance reserves must be reduced by the net value of risks reinsured on a YRT basis; the IRS reasoned that, "because a comparison must be made to determine which is greater—the net surrender value or the Federally prescribed reserves—the net surrender value is, for this purpose, treated as a component of reserves." According to the TAM, section 807(d)(1) determines the amount of life insurance reserves for a contract, regardless of the role played by the net surrender value and, thus, Treas. Reg. §1.801-4(a) requires reduction of life insurance reserves, even

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though the ceding company's reserves are based on the net surrender value of the contract and the reinsurer assumes no liability with respect to the payment of the net surrender value.

The TAM's analysis is wrong for a number of reasons. Treas. Reg. §1.801-4(a) probably does have continuing applicability under the current law, but only to the extent it is interpreting provisions that are carried over from the 1959 Act. The purpose and scope of Treas. Reg. §1.801-4(a) can best be understood in the context of the requirement that, to qualify as a life insurance reserve under 816 and its predecessor, the reserve must be "required by law." The drafters of the regulation wanted to make it clear that when a ceding company continues to hold reserves with respect to reinsured risks, because state law denies reserve credit (for example, because the reinsurer is unauthorized), the portion of the reserves held by the ceding company with respect to the reinsured risks will not be included in the ceding company's life insurance reserves required by law.'" What was carried over from the 1959 Act was the "required by law" requirement for life insurance reserve qualification in section 816 and, at least in concept, the actuarially computed reserve in section 807(d)(2). Neither the definition of net surrender value in section 807(e), nor the use of the net surrender value as a floor for the actuarially computed reserve is a concept carried over from the 1959 Act. Moreover, prior to the adoption of current law tax reserve rules under the 1984 Act, the position of the IRS was that "surrender values in excess of reserves otherwise required" reported in Exhibit 8G of the Annual Statement were not life insurance reserves. Similarly, under current law, the IRS frequently has argued that changes in the computation of the net surrender value under section 807(e) are not subject to section 807(f) because the net surrender value is not a reserve item. So, if Treas. Reg. §1.801-4(a) applies to life insurance reserves, it may have little or no application to the net surrender value.

The key determination should be whether the reinsurer has assumed the risk that it will be required to reimburse the ceding company for a portion of the cash surrender value in the event of a death or surrender of the contract. If risks relating to the cash surrender value have not been reinsured, there is no reason why Treas. Reg. §1.801-4(a), or any other tax rule, should operate to reduce the ceding company's net surrender value as defined in section 807(e).

At its core, the TAM's conclusion seems to be based on the concern of the IRS is that, absent a reserve reduction for the YRT credit by the ceding company, the total amount of reserves deducted by the ceding company and the reinsurer, combined, will exceed the amount that the ceding company alone could deduct absent the reinsurance. But, this is not an unusual consequence of reinsurance when benefits that previously were covered by one contract (issued by the ceding company) become covered by two contracts (the ceding company's and the reinsurance contract). Section 807 itself contemplates that the aggregate amount of the deductible reserves may increase if the taxpayer takes steps to ensure that benefits unrelated to the net surrender value have a separate charge, so that the tax reserves for such benefits can be computed under section 807(d) and are excluded from the net surrender value comparison for the contract (e.g. the treatment of qualified supplemental benefits under section 807(e)(3)).

Undoubtedly, the position of the IRS with regard to the TAM will be challenged.

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The Notice provides examples of transactions that would not require a change to the 2001 CSO, noting that changes, modifications or exercises of contractual provisions include addition or removal of a rider, an increase or decrease in death benefit (if the change is not underwritten), and a change from an option 1 to option 2 contract or vice versa.

The inclusion of the parenthetical (if the change is not underwritten) caused some concern as to the extent to which changes to existing contracts would require the use of the 2001 CSO to meet the mortality safe harbor after the change. Based on comments from IRS representatives at the SOA fall 2004 seminar on product tax matters, it appears that the IRS is seeking to strike a balance between permitting companies to use the 1980 CSO for most changes, while not giving companies an unrestricted right to increase coverage without limitation while still maintaining qualification under the 1980 CSO. The broad tax law concept of a "material change," which is distinct from the term as applied under section 7702A, appears to govern the potential change as it relates to the applicable reasonable mortality requirements. While no clear line exists for distinguishing one type of underwritten increase from another, it appears that limited increases in coverage would be permissible, while extraordinary increases would require the use of the 2001 CSO on the new segment.

Issues not Addressed

Notice 2004-61, while clarifying many issues related to the transition to the 2001 CSO, is silent on a number of industry concerns. Among the most important of these is the treatment of the maturity date. Under the 2001 CSO Table, the terminal age of the mortality table has been extended to 121, compared to age 100 under the 1980 CSO. Consistent with the terminal age of the 1980 CSO (and 1958 CSO), section 7702(e)(1)(B) deems a life insurance contract's maturity date to be between the insured's ages of 95 and 100. Section 7702 does not require a life insurance contract to endow at age 100, nor does it preclude an insurer from charging for mortality beyond age 100. There may, however, be a question of whether and how the limits continue to apply beyond age 100, the latest "deemed" maturity age under the statute. Similarly, the notice does not provide any guidance related to the use of multiple life or substandard mortality.

Future Developments

The American Council of Life Insurers filed comments with the IRS addressing many of the questions discussed above. It is possible that, in response to the questions that have been raised, additional clarification will be forthcoming. It is also possible, however, that the IRS will consider finalizing the proposed mortality regulations, although the issues of substandard and multiple life mortality are not easily resolvable. For now, Notice 2004-61 provides a new and welcome chapter in the mortality story under sections 7702 and 7702A.

Coming Soon: Survey on the Role of the Tax Actuary

The Taxation Section is putting together a survey to understand actuarial involvement in the company tax function. The survey will be coming out this spring and it will be asking you about the actuary's participation in many aspects of company tax, and your company's tax actuarial career path. Your prompt response to this survey will be greatly appreciated.

Taxation of Distributions

Douglas Hertz

The rules governing the tax treatment of distributions from life insurance or annuity contracts are complex. Worse, the relevant IRC section, section 72, seems at times to be the product of a conspiracy in restraint of understanding. Unfamiliar phrases (e.g. "income on the contract," and "investment in the contract") serve to further make the subject hard to approach. This article will be one actuary's attempt to shed some light on the subject.

Let's start with those phrases. Most actuaries who deal with policyholder tax matters use the word "basis," but section 72 calls it "investment in the contract." Similarly, we laypeople tend to use the word "gain" where section 72 opts for "income on the contract." Just knowing this much helps one to penetrate the section 72 fog.

In general, distributions are taxed in three ways. The first approach is the first in, first out (FIFO) approach and is thought of as the friendly approach, since it defers tax. Under this approach, basis is distributed first, and no distributed amount is taxable until all basis is gone. The second approach is last in, first out (LIFO) and it does the reverse of FIFO. Under LIFO, gain is distributed first, and no distributed amount is free of tax until all gain is gone from the contract. Finally, the third (pro-rata) approach compromises between these two extremes and views any distribution as a mix of taxable gain and basis in the same proportion as existed in the contract just before the distribution. (This pro-rata taxation applies to contracts under qualified plans under section 72(e)(8) and is beyond the scope of this article.) How distributions are characterized, i.e., as basis or gain, is the job of section 72.

Section 72 allocates any "amount received" by the policyholder under the contract between two categories: income on the contract (gain) or investment in the contract (basis). The sum of these two amounts equals the amount received. The portion allocated to gain is taxable to the recipient, while the amount allocated to basis reduces investment in the contract and is not taxable. To determine this allocation, we look to the definitions in section 72.

Investment in the contract as of any date is defined by section 72(e)(6) as the total amount of premium or other consideration paid for the contract before that date less the aggregate amount received by the policyholder from the contract before that date, to the extent the amount received was excluded from gross income for income tax purposes. (We will later see a modification to adjust for taxed policy loans, but that can wait.) Income on the contract is effectively defined in section 72(e)(3) as the excess of contract cash value before reduction for any surrender charge over the investment in the contract.

Allocation of distributions under section 72 is done one way for annuities and modified endowment contracts (MECs), and another way for non-MEC life insurance contracts. For non-MECs, section 72(e)(5) applies, and the amount received is allocated to income on the contract to the extent it exceeds investment in the contract at the time of distribution. That is, the FIFO method of taxing applies and basis is fully recovered before any income amount is recognized. Also, for a non-MEC, a policy loan is not treated as a distribution and does not create an amount received by the policyholder.

For an annuity or a MEC, section 72(e)(10) makes section 72(e)(2)(B) applicable, and the amount received is allocated to income on the contract to the extent it does not exceed the income on the contract at the time of distribution. That is, the amount received is taxable income first to the extent of gain, and only after all gain has been taxed is there any allocation to basis. This is the LIFO method of taxing distributions. However, we note that section 72(e)(5)(E) provides special treatment for full surrender of a contract, which creates an exception to the rule discussed so far in this paragraph. On full surrender, the amount received is included in gross income, but only to the extent it exceeds investment in the contract—the FIFO rule. This rule allows full basis recovery for annuities and MECs in circumstances where there is a full surrender in the presence of a surrender charge. (Suppose a MEC with basis $800 and gain $200,

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hence cash value $1000, is surrendered. Assume a $100 surrender charge applies. Without this special rule, income on the contract of $200 would be LIFO taxed, and of the $900 amount received, only $700 would represent basis recovery. The surrender rule prevents this.) Finally, for annuities and MECs, policy loans are treated as distributions and create an amount received by the policyholder (section 72(e)(4)(A)). This applies to loans taken to pay policy loan interest as well as to loans taken as cash or to pay premiums.

Policy dividends are given special treatment. A dividend or similar amount that is retained by the insurer as a premium or consideration for the contract is not treated as a distribution and does not create an amount received due to section 72(e)(4)(B). Policy dividends also do not have any effect on investment in the contract (basis). This favorable treatment is not extended to partial surrenders or policy loans applied to pay premiums. Thus, partial surrenders or policy loans create distributions for a MEC or an annuity, which may well be fully or partly taxable. Similarly, a dividend applied to reduce a policy loan is treated as a distribution for both MECs and non-MECs. These distributions reduce basis only to the extent they are not taxable.

The taxing of policy loans from MECs and annuity contracts requires an adjustment to basis accomplished by the final sentence of section 72(e)(4)(A). The policy loan does not affect the cash value of the contract and neither will any repayment of the loan. Any taxed portion of the loan is, however, added to the investment in the contract (basis). If a policy loan is applied to pay premium, the basis is increased by any taxed portion of the loan and further increased by the amount applied as premium (just as any premium payment increases basis).

Finally, we should note that under section 72, the investment in the contract is not always the same as section 7702(f)(1) premiums paid. Three differences come to mind. The first occurs when a contract is issued as an exchange, in which gain is not recognized due to the operation of section 1035. Under section 7702, the entire amount of exchange money counts as premiums paid. However, section 1031(d) intervenes to create a carry-over basis from the old contract to the new one. The effect of this carry-over is to treat income on the old contract, not taxed in the exchange, as income on the new contract. For completeness we note that if the policyholder in a section 1035 exchange receives money (boot), in addition to a new contract, the money is taxable to the extent there is gain in the old contract and any excess of the boot over the prior contract gain will reduce the carry-over basis of the new contract. (section 1031(b) and Reg. Section 1031(d)-1(b)).

The second way basis can differ from premiums paid is through the taxation of policy loans from MECs. As previously noted above, the taxed portion of the loan increases investment in the contract (basis), but there is no effect on premiums paid.

The third difference is created by a special rule in section 7702(f)(1)(B) allowing amounts taxable under the force-out rule of section 7702(f)(7)(B), (E) to reduce premiums paid under section 7702. This does not mean that these amounts reduce section 72 investment in the contract. We note that the same treatment could have been explicitly given to amounts distributed from a MEC under the 60-day rule of section 7702(f)(1)(B) and treated as taxable under section 72, but the opportunity to do it right seems to have been missed. My suspicion is that there are companies with guideline premium tested contracts taking the position that an amount can be premium returned under section 7702 regardless of its treatment under section 72. (Actuaries can be so literal minded; lawyers have a way of characterizing a thing as a mouse for some purposes and an elephant for others.) Those taking this position would allow an amount distributed from a MEC to reduce premiums paid under section 7702 even if the amount was fully taxable under the MEC rules. If this becomes a matter of interest at your company, consult the company tax attorney to establish a company position.

You should be aware that section 72 does other things we have not discussed. In particular, it imposes additional tax (penalty tax) on certain distributions from MECs and annuities (see section 72(q) and (v)) and provides for taxation of annuities in the payout stage. It also deals with some aspects of the taxation of qualified plans.

TABLE 1
SUMMARY OF TAXATION OF DISTRIBUTIONS UNDER IRC SECTION 72

	TIMING OF TAX	POLICY LOANS	PENALTY TAX
NON-MEC LIFE INSURANCE	FIFO	NOT TAXED	NONE
MECs	LIFO	TAXED WITH BASIS ADJUSTMENT	10% WITH EXCEPTIONS
ANNUITY	LIFO	TAXED WITH BASIS ADJUSTMENT	10% WITH EXCEPTIONS

Revenue Ruling 2005-6: Guidance on QABs under IRS Sections 7702 and 7702A

John T. Adney, Joseph F. McKeever III and Craig R. Springfield

On January 19, 2005, the Treasury Department and the Internal Revenue Service (the "Service") responded to a life insurance industry request[1] for guidance on the treatment of qualified additional benefits ("QABs") under sections 7702 and 7702A of the Internal Revenue Code through the release of Revenue Ruling 2005-6 (the "Ruling").[2] The Ruling provides two important pieces of guidance. First, it confirms the position that the Service had taken in private letter rulings that charges for QABs are subject to the "reasonable expense charge rule" of section 7702(c)(3)(B)(ii), and not the "reasonable mortality charge rule" of section 7702(c)(3)(B)(i), for purposes of determining whether a contract qualifies as a life insurance contract under section 7702 or constitutes a modified endowment contract under section 7702A (a "MEC"). Second, in response to the concerns that companies had expressed to the Treasury Department and the Service, the Ruling provides special transition relief – both generous and without precedent under the statutes affected – for issuers whose compliance systems have not properly accounted for QABs.

Statutory Framework

Section 7702 sets forth a definition of a "life insurance contract" for purposes of the Internal Revenue Code. In order to meet that definition, a contract that is a life insurance contract under applicable, e.g., state, law must (1) satisfy the "cash value accumulation test" (the "CVA test"), or (2) meet certain "guideline premium" and "cash value corridor" requirements (the "GP test"). Also, a contract that constitutes a life insurance contract under section 7702 will be characterized as a MEC (resulting in less favorable tax treatment than non-MEC life insurance contracts) if it fails to meet the "7-pay test" of section 7702A (or is received in exchange for a contract that is a MEC).

The Code sets forth rules regarding the assumptions with respect to mortality and expense charges that must be used in determining net single premiums under the CVA test, guideline premiums under the GP test, and 7-pay premiums under the 7-pay test. In particular, such determinations must be made in accordance with the reasonable mortality charge rule and reasonable expense charge rule of sections 7702(c)(3)(B)(i) and (ii), respectively. The reasonable mortality charge rule provides, in part, that the determinations must be based on reasonable mortality charges that do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued. (For contracts issued in the past, these mortality charges generally are ones based on the 1958 or 1980 Commissioners Standard Ordinary ("CSO") tables, depending on when the contract was entered into. The Service provided guidance last year in Notice 2004-61,[3] regarding when determinations for newly issued contracts would need to be based on the 2001 CSO tables.) While the reasonable mortality charge rule requires mortality charges to be "reasonable," it does not require that the charges taken into account be charges that are expected to be actually paid. In contrast, the reasonable expense charge rule provides that determinations under sections 7702 and 7702A must also be based on "any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid."

Determinations of guideline premiums, net single premiums and 7-pay premiums under sections 7702 and 7702A generally are made with respect to the "future benefits" under a contract, which includes the amount of any death or endowment benefit. Also, reasonable expenses other than with respect to QABs may be taken into account in determinations of guideline premiums, but not for net single premiums or 7-pay premiums. For QABs, the Code imposes what can almost be thought of as a hybrid rule. Specifically, under section 7702(f)(5)(B), the charges for QABs are treated as future benefits that can be reflected in the determinations, rather than the benefits actually provided by a QAB. Section 7702(f)(5)(A) defines QABs as any (i) guaranteed insurability benefit, (ii) accidental death or disability benefit, (iii) family term coverage, (iv) disability waiver benefit or (v) other benefit prescribed under regulations (although no such regulations have been prescribed).

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[1] *Davis & Harman LLP submitted the request on behalf of a group of life insurance companies in June, 2003. Also, the American Council of Life Insurers, the principal life insurance industry trade association, subsequently made a similar request.*

[2] *2005-6 I.R.B. 471. Also, references herein to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").*

[3] *2004-41 I.R.B. 596.*

Past Practices of Insurers and Private Rulings from the Service

Despite, or perhaps because of, the special rule for QABs treating their charges as "future benefits," many insurance companies adopted an interpretation of the Code's requirements that differs from the position ultimately adopted by the Service in the Ruling. While it is clear under the applicable statutory rules that QAB charges are treated as "future benefits," rather than the QABs themselves, for purposes of making determinations under sections 7702 and 7702A, what has been unclear is whether those charges are subject to the reasonable mortality charge rule or the reasonable expense charge rule. If the reasonable mortality charge rule governs, it typically would be permissible for the guaranteed charges for the QAB to be reflected in the determinations. In contrast, if the reasonable expense charge rule governs, only such charges that are reasonably expected to be actually paid may be reflected. Given that expected actual charges for QABs are in many cases materially less than 1980 CSO-based charges (or the guaranteed charges for the QABs), there can be a significant difference between the guideline premiums, net single premiums and 7-pay premiums resulting from application of one rule versus the other.

Many life insurance companies have taken the position that the reasonable mortality charge rule applies in accounting for QABs under sections 7702 and 7702A. As noted earlier, under section 7702, charges for QABs are treated as "future benefits" under section 7702, which is the same way that death benefits are treated. For death benefits, it is clear that the reasonable mortality charge rule governs how the benefit is reflected in the determinations under sections 7702 and 7702A. Many companies concluded that Congress' intent was to treat QAB charges, given their status as future benefits, in the same manner. Reinforcing this view is the fact that the reasonable expense charge rule, on its face, states that it only addresses expense charges "other than mortality charges." Some reasoned that since family term coverage QABs (which are perhaps the most significant QABs in terms of the effect they often have on the determinations under sections 7702 and 7702A) involve charges that economically are comparable to mortality charges, there existed an especially strong case for applying the reasonable mortality charge rule to account for such QABs. Thus, in the case of family term coverage, whether due to the treatment of QAB charges as future benefits or due to the underlying economic nature of the charges, it was difficult for insurance companies to reconcile application of the reasonable expense charge rule with the statutory prescription that this rule, on its face, does not apply to account for "mortality charges."

In 2001, the Service issued the first in a series of private letter rulings which concluded that the reasonable expense charge rule applies to QABs and that the insurance company's failure to apply such rule was a reasonable error and consequently waived pursuant to section 7702(f)(8). (See PLR 200320020 (Feb. 6, 2003), PLR 200227036 (April 19, 2002), PLR 200150018 (Sept. 13, 2001), and PLR 200150014 (Sept. 12, 2001).) These private letter rulings were not precedential (i.e., they could be relied upon only by the taxpayers requesting them) and were issued to life insurance companies that acknowledged error with respect to their treatment of QABs under section 7702. The effect of the rulings is that, with respect to the failed life insurance contracts identified to the Service, the error was treated as never having occurred for tax purposes and, hence, the potential tax liability that policyholders of such contracts faced due to the failure of their contracts to comply with section 7702 was eliminated. These rulings also informed the life insurance industry of the Service's then-applicable position with respect to QABs. Given the non-precedential status of the private rulings, however, many companies were presented with the difficult task of either conforming to the Service's view as thus expressed, which in many cases would entail very substantial costs, such as in modifying compliance systems, or choosing to ignore the rulings and run the risk of additional contract failures and increasing tax exposure.

The Ruling

The Ruling holds that the reasonable expense charge rule of section 7702(c)(3)(B)(ii) applies to charges for QABs. This is not surprising, given the Service's position in the private rulings just described. By publishing this position in a revenue ruling, however, the Service now has accorded it precedential weight with respect to all taxpayers. Perhaps more importantly, the Ruling provides relief to life insurance companies who previously concluded that the reasonable mortality charge rule, rather than the reasonable expense charge rule, governed the treatment of QABs. This relief comes in the form of special rules and procedures for entering into a closing agreement with the Service.

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The Ruling's grant of relief for those who previously applied the rules incorrectly (in the Service's view) recognizes that the normally applicable procedures for addressing errors under sections 7702 and 7702A would not produce an equitable result in the present circumstances. Under the Service's generally applicable procedures, life insurance contracts failing to comply with section 7702 or section 7702A can only be brought into compliance through a proceeding with the Service, i.e., receipt of a waiver under section 7702(f)(8) or execution of a closing agreement covering failures to comply with section 7702, and execution of a closing agreement covering inadvertent MECs. Under each of these procedures, it is generally necessary to correct systems and contracts so that the error causing the failures is corrected. For example, for a contract failing under the GP test, correction often takes the form of returning premiums in excess of the properly determined guideline premium limitation. Also, in the case of closing agreements, it is often necessary to pay a significant "toll charge." In the case of closing agreements under section 7702, for instance, the toll charge is intended to serve as a proxy for the federal income taxes that owners of the failed life insurance contracts would have paid if they had included the income on the failed contracts (as defined by section 7702(g)) in their income. Deficiency interest also is payable as part of the toll charge.

The Ruling's special rules and procedures deviate from the normal procedures in two significant respects. First, they do not require a life insurance company to take corrective actions with respect to QABs that have been accounted for using the reasonable mortality charge rule, if the issuer requests relief through a closing agreement before Feb. 7, 2006. Second, a special toll charge structure is adopted which generally involves much reduced costs compared with those otherwise applicable. Under the special toll charge structure, the charge is determined under a sliding scale based upon the aggregate number of contracts for which relief is requested. The same special toll charge structure applies regardless of whether the failure is under section 7702, section 7702A, or both.

The Ruling's relief provisions are set forth in the "Application" part of the Ruling, which is divided into three separate alternatives—A, B and C. The remainder of this discussion details the specifics of the relief provided by the Ruling.

Alternative "A." The first alternative of the Application part of the Ruling states that, where an issuer's compliance system improperly accounts for QAB charges but no contracts have failed under section 7702, the issuer may correct its system to account for charges using the reasonable expense charge rule without any need to contact the Service. It appears that this alternative is simply a restatement of actions that issuers may take under existing law. Thus, the alternative serves as a reminder to life insurance companies that they do not need to involve the Service in the circumstance where no contracts have failed to meet the definitional tests of sections 7702 and 7702A. At the same time, the alternative does not provide any relief, in and of itself, since the determination that no contracts fail must be made using the reasonable expense charge rule for QABs, and thus this alternative contemplates correction of compliance systems.

Alternative "B." The second alternative of the Application part of the Ruling states that, where an issuer's compliance system improperly accounts for QAB charges and, as a result, some contracts do not meet the definition of life insurance contract under section 7702(a), the issuer may request a closing agreement on or before Feb. 7, 2006 on the basis described below. While this alternative's introductory language refers to contracts that do not meet the definition of life insurance under section 7702(a), it seems clear from the remainder of the discussion under this alternative that the intent was for the relief provided also to be available for inadvertent MECs under section 7702A, even though such contracts are in compliance with section 7702. In addition, the relief provided is not by its terms limited to any particular types of QABs, i.e., all are encompassed, or to particular determinations under sections 7702 or 7702A, i.e., errors under the GP test, the CVA test and the 7-pay test are all encompassed.

Under a closing agreement entered into pursuant to this Alternative B:

(1) The issuer must identify all contracts administered under the compliance system, but need not identify whether they fail under section 7702 or section 7702A. The Ruling does not state the precise manner in which such identification must be made. Under closing agreements addressing section 7702 failures in other contexts, policy numbers are used to identify contracts.

(2) The identified contracts will not be treated as failing under section 7702 or as inadvertent MECs under section 7702A by reason of improperly accounting for charges for existing QABs. This relief will extend to future charges resulting from an increase in an existing QAB or the addition of a new QAB pursuant to the exercise of a right that existed in the contract before April 8, 2005. However, the relief under the closing agreement will not extend to improper accounting for charges for an increase in an existing QAB, or the addition of a new QAB, that are not pursuant to the exercise of a right that existed in the contract before that date.

While there is some uncertainty on the point, the Ruling appears to allow inclusion of contracts issued on and after April 8, 2005, as long as the request for relief identifying such contracts is made before February 7, 2006. If this is correct, the availability of relief for such contracts allows issuers a transition period in which they may continue marketing their products while modifying systems (and perhaps policy forms) to apply the reasonable expense charge rule to QABs under new contracts. In addition, while the denial of relief for increases in and additions of QABs was perhaps a reasonable exception for the Service to adopt (since, absent such an exception, such changes to an existing contract's QABs could be motivated by a desire to obtain the benefit of such relief), no such exception is necessary for newly issued contracts. It is very unlikely that the prospective purchaser of a new contract would be motivated by the presence or absence of transition relief pertaining to use of the reasonable expense charge rule for QABs.

(3) No corrective action need be taken with respect to the compliance system or with respect to contracts identified in the closing agreement. To the extent the compliance system will be used to administer newly issued contracts, such system will of course need to apply the reasonable expense charge rule. As discussed above, at the latest, contracts issued on and after February 7, 2006 would need to be administered in accordance with the reasonable expense charge rule.

(4) In lieu of the amount of tax and interest that would be owed by the policyholders under a normal section 7702 or section 7702A closing agreement, the amount due under a closing agreement under this Alternative B will be based on a schedule contained in the Ruling that sets forth a sliding scale of charges keyed to the "number of contracts for which relief is requested." This scale ranges from $1,500 for 20 contracts or fewer, to $50,000 for over 10,000 contracts.

When the Ruling states that the sliding scale charge will be based on the "number of contracts for which relief is requested," its statement seemingly is intended to correspond to the requirement of paragraph (1) on page 16, which states that "the issuer must identify all contracts administered under the compliance system." Thus, the number so identified would be the same number for which relief is requested. There are several points of uncertainty, however, regarding the manner in which the toll charge is calculated.

For example, is it permissible for an issuer to include all contracts that it has administered improperly and for which it was responsible, regardless of whether such contracts were originally issued by the company? Given that the insurance industry has undergone considerable merger and acquisition activity in recent years, in efforts to promote greater efficiencies, in many cases an insurance company and its affiliates administer and are responsible for the tax compliance of contracts originally issued by other insurers (in some cases many other issuers). Application of the $50,000 cap for all such contracts would seem appropriate, although the Ruling is not clear on this point.

As another example of uncertainty, consider the situation where a company wants to apply the reasonable expense charge rule retroactively to all of its in-force contracts, perhaps because of systems considerations, and then obtain relief only for contracts that fail to comply with section 7702. The company presumably could request a private letter ruling from the Service seeking waivers for the errors. Such action would be consistent with the four private letter rulings that already have been issued by the Service, and the Ruling itself, and in particular its analysis and provision of relief, lends additional support for the view that errors in

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accounting for QABs under section 7702 are "reasonable errors," an essential element of entitlement to waiver relief under section 7702(f)(8). If the company wanted instead to utilize Alternative B of the Ruling, is it available in this circumstance, and in what manner? (We comment on this question as part of the discussion of Alternative C below.)

(5) The request for a closing agreement must be submitted with the user fee required by applicable procedures governing requests for private letter rulings (generally $7,000 for 2005).

Alternative "C." The third and final alternative of the Application part of the Ruling states that after Feb. 7, 2006, an issuer whose compliance system improperly accounts for QAB charges may request a closing agreement under the same terms and conditions as described under Alternative B on (page 16), except that (1) the closing agreement must identify the contracts that fail to satisfy the requirements of section 7702 or are inadvertent MECs under section 7702A, and (2) the closing agreement must require the issuer to correct its compliance system and to bring the identified contracts into compliance with section 7702 or section 7702A, as applicable.

The Ruling is silent regarding the effect of the Ruling on the existing waiver request process under section 7702(f)(8). The Ruling does not state that waivers are no longer available, e.g., there is no provision in the Ruling stating that it sets forth the exclusive means for addressing errors in accounting for QABs. Also, as noted above, the Ruling's analysis and relief implicitly recognize the reasonableness of this type of error. The presence of Alternative C, however, given its requirement of correcting failed contracts and the need to pay the sliding scale toll charge, may imply that errors in accounting for QABs will not be viewed as reasonable errors beginning at some time in the future (possibly after Feb. 7, 2006, the effective date for use of Alternative C), rendering waivers unavailable.

It is clear that the number of contracts actually failing the statutory tests, rather than the number administered on the compliance system, is intended to be used to determine the sliding scale toll charge under Alternative C. As discussed above, some issuers may want to apply the reasonable expense charge rule retroactively and seek relief under the Ruling (and calculation of the sliding scale toll charge) only for failed contracts. Alternative C permits this, but only for requests made after Feb. 7, 2006. If the issuer wants to make the request sooner, it may be possible to do so under Alternative B and simply identify the failed contracts. While Alternative B requires identification of "all contracts administered under the compliance system" and payment of a toll charge based on "the aggregate number of contracts for which relief is requested," it seems reasonable that the Service would allow identification of, and payment of the toll charge with regard to only the failed contracts under this alternative in circumstances where the issuer is not seeking any relief for any other contracts. Such an interpretation not only would reconcile Alternatives B and C, but would also be consistent with the principles underlying Alternative A, i.e., that there is no need to involve the Service for contracts that comply (based on retroactive application of the reasonable expense charge rule) and will be administered in accordance with the correct rule on an ongoing basis.

Conclusion

The Ruling represents a positive and reasonable resolution of a significant problem faced by many life insurers due to the uncertainty as to whether QABs should be accounted for under the reasonable expense charge rule or the reasonable mortality charge rule described in section 7702. By providing procedures which avoid retroactive application of new guidance in light of equitable considerations, and under which life insurance companies are required to pay only a reduced toll charge, the Service has provided a reasonable and workable form of relief.

Life insurance companies should review their treatment of QAB charges, and if their treatment differs from the position ultimately adopted by the Service in the Ruling, determine which of the Alternatives above is the most prudent for them.

The Service and U.S. Treasury Department are to be commended for their thoughtful consideration of this matter, and hopefully the Ruling will serve as a model for future action as and when similar situations arise.

BOOK REVIEW

Life Insurance & Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A, Society of Actuaries by Christian J. DesRochers, John T. Adney, Douglas N. Hertz and Brian G. King

Society of Actuaries
336 pages, $125,
ISBN 0.9 75 9337-1-X.

Tom Quinn

The well-known Canadian author Allistair McLeod says writers write about what worries them. If so, the authors of *Life Insurance & Modified Endowments under Internal Revenue Secitons 7702 and 7702A* must worry a lot about the tax law definition of life insurance contracts and modified endowment contracts. The authors (admittedly known to this reviewer) are three actuaries, who sometimes think like tax attorneys, and one attorney, who sometimes thinks like an actuary. Their book does a really splendid job of dissecting the tax law definition of life insurance/modified endowment contracts. This is not an easy task.

It is probably a sad commentary on the complexity of the tax law that two relatively short provisions of the Internal Revenue Code (short at least when compared, for example, with section 72 regarding annuities) is now the subject of a 300+ page book. Simply stated, the book fills a large void and should be on your list of things to buy this year. Over time it will be far more useful than that I-POD you may be coveting. It is truly unfortunate the book was not available when I was more actively involved with issues relating to sections 7702/7702A.

Anyone who deals with the tax law definition of a life insurance contract quickly realizes the need to master some basic actuarial principles. Perhaps this is why so few tax attorneys, otherwise well versed in subchapter L of the Internal Revenue Code regarding insurance company tax matters generally, have failed to achieve even a rudimentary understanding of product tax issues. Reading this book will greatly assist those who fear mastering sections 7702/7702A requires membership in the Society of Actuaries or an advanced degree in mathematics. The authors point out that achieving a basic understanding of sections 7702/7702A requires at least a partial immersion into basic actuarial principles. Thus, the "actuarial discussion" begins early in the book (page 21) but the "non actuarial" reader should not despair since the formulae one needs to grasp are explained in reasonably understandable language.

The book has a very useful and very detailed table of contents and, unlike some technical books, also has an extensive index. Due to the absence of definitive regulatory guidance by the IRS in this area (many industry observers sincerely believe the IRS will never issue final regulations under sections 7702/7702A) the authors took considerable effort to summarize IRS "rulings position" on a number of issues involving the interpretation of sections 7702/7702A. This aspect of the book is extremely helpful particularly for those who may not be trained in the arcane way one must search for tax material in the product tax arena. You will be able to justify buying the book solely because it contains the citations of virtually all of the rulings issued by the IRS concerning sections 7702/7702A.

Even though the authors have had very extensive involvement with sections 7702/7702A for many years (remember section 7702 has been "on the books" for 21 years now), I detected no inherent bias by the authors concerning the interpretations rendered by the IRS to date regarding sections 77702/7702A. Refreshingly, the authors allow the IRS rulings, announcements, etc. to speak for themselves. You will have to pay close attention to the footnotes in the book, however, since that is where most of the rulings, etc. are cited. For example, the chapter on failed contracts has 117 footnotes. Remember, the book is designed to be a reference tool and references it does contain.

The authors dutifully note life insurance companies are likely to be in noncompliance with some aspects of the various definitional limitations of sections 7702/7702A. Thus, the book appropriately contains a very useful discussion of how life insurance companies may correct errors, seek waivers for noncompliance,

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obtain closing agreements from the IRS or otherwise "rehabilitate" a failed life insurance contract. Those responsible for tax compliance will find the discussion of great value even if the company you represent already initiated a correction program.

Since there is a fair amount of "consolidation" taking place within the life insurance industry the authors also include a very helpful discussion of the treatment of failed contracts discovered during the "due diligence" process associated with the typical acquisition.

Early on in the book the authors note how the current rules concerning the tax law treatment of life insurance/modified endowments evolved from historical precedents "generally in response to the emergence of specific types of life insurance products" — a reference to some life insurance products which took on very investment-oriented features years ago. Thus, the authors note how understanding the technical requirements of sections 7702/7702A first requires an understanding of the tax policy issues surrounding enactment of the provisions. The book explores in considerable detail how cash surrender value contracts developed and their historical treatment under the earliest versions of the income tax in this country. The authors also discuss the "new generation" of life insurance products that evolved in the late 1960s and 1970s. The authors note the aggressive marketing of single premium life insurance which many in the industry believed at one point was the "last remaining tax shelter." Simply stated, the authors, three of whom were actively involved in discussions with government representatives concerning the creation of a tax law definition of life insurance, provide a very useful rationale for why sections 7702/7702A exist today.

Many of us involved in life insurance company tax issues in the late 1970s and early 1980s will likely not forget these times, but if your memory has failed, reading the last two chapters of the book will clearly refresh it. Since everyone involved with sections 7702 and 7702A today was not around when these provisions were added to the Internal Revenue Code, it may have been more useful if the authors had for "chronological clarity" included this historical/policy discussion at the beginning of the book.

The book also contains a very useful glossary of the jargon associated with sections 7702/7702A. The glossary is thorough (for example, it defines attained age increment and decrement) and is easy to use.

The extensive appendices are another useful feature of the book. The authors have included the statutory language of sections 7702/7702A and section 101(f) and pertinent portions of the legislative history surrounding these provisions. It is very convenient to have in one place the various explanations of the congressional tax writing committees regarding these provisions.

Don't wait for the video version of the book. Buy it now. It will be a welcome addition to your tax library.

And the winner is: *"Taxing Times"*

Actually, multiple entrants choose this clever name for our newsletter. A name was drawn from those entrants and...

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Gary won a $25 gift certificate and bragging rights.

Thanks to all our participants for your entries.