Internal Revenue Code Sections 7702 and 7702A: Introduction to the Tax Rules Affecting Life Insurance Products Seminar
May 8, 2013

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Internal Revenue Code Sections: 7702 & 7702A:

Introduction to the Tax Rules Affecting Life Insurance Products

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Toronto, CN

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Overview

- Part I: Requirements for Qualification as Life Insurance under the Internal Revenue Code
- Part II - IV: Computing the IRC Section 7702 and 7702A Limitations:
  - Methods and Assumptions
  - Future Benefits, Death Benefits and Qualified Additional Benefits
  - Adjustments, Material Changes and Exchanges
- Part V: Managing Product Tax Risk

Part I:
Requirements for Qualification as Life Insurance under the Internal Revenue Code

Life Insurance and Modified Endowments
Under IRC Sections 7702 and 7702A
Applicable Law and Sources of Information

- Provisions of the Internal Revenue Code (IRC) related to life insurance products
- Primary source of rules is statutory
  - IRC Code Sections 72, 101, 7702 & 7702A
- Additional sources of information:
  - Legislative history
  - IRS pronouncements - regulations, revenue rulings, revenue procedures, notices & private letter rulings

Life Insurance Tax Treatment

- Death benefits paid to the beneficiary are free of income tax (IRC 101(a)(1))
- Increments in the cash surrender value are not includible in the taxable income of the policy owner (IRC 72(e))
  - Inside buildup = interest and gains earned inside a life insurance policy
  - Not taxed until a distribution or surrender occurs
Statutory Limitations

- **TEFRA: IRC Section 101(f)**
  - Flexible premium contracts issued before 1/1/85
  - Addressed universal life tax issues

- **DEFRA: IRC Section 7702**
  - Applies to all life insurance contracts issued after 12/31/85
  - Actuarial tests for qualification

- **TAMRA: IRC Section 7702A**
  - “MEC” testing required for contracts entered into on or after 6/21/88
  - “Reasonable” mortality and expenses effective for contracts entered into on or after 10/21/88

IRC Sections 7702 and 7702A

- Gateway for a life insurance policy to receive “favorable” tax treatment

- **IRC Section 7702** defines a “life insurance contract”
  - Failure to meet 7702 results in current tax on inside build-up (effectively grossed-up for cost of insurance cost)

- **IRC Section 7702A** defines a “modified endowment contract” (“MEC”)
  - No meaning outside of IRC Section 7702A
  - Deals with pre-death distributions from the contract (LIFO tax treatment for distributions, including loans, and penalty tax)
Requirements for Qualification

- Life insurance under “applicable law”
  - A single integrated contract under state or foreign law
- Meets either the cash value accumulation test (CVAT) or the guideline premium test (GPT) under IRC Section 7702
  - Regulates relationship of the premium, death benefit and cash value
- 7-pay test under IRC Section 7702A for MEC status

Applicable Law Requirement

- A “single, integrated life insurance contract” under “applicable state or foreign law.”
  - Courts and the IRS have found life insurance contracts to exist where there is no commercial life insurance contract
- “[T]he presence of an insurable interest is a necessary component of a life insurance contract [to be] valid under state law and, therefore, IRC Section 7702(a) as well.”
  (Dow Chem. Co. v. U.S. 250 F. Supp 2d 748)
Classes of Life Insurance

- IRC Section 7702 compliant: non-MEC
  - Premium-first distributions during the insured’s life (FIFO)
- Modified Endowments (MECs)
  - Annuity distribution rules (LIFO)
- Non-qualifying
  - Currently taxable under IRC Section 7702(g)

Importance of determining the proper “classification”
- Sets forth the reporting requirements for distributions to policy owners and beneficiaries
- Failing to properly classify contracts exposures administrators to potential withholding and reporting errors, policy owner complaints, etc.

Model or Test Plan

- Contractual benefits and statutory assumptions used to compute limitations
  - Future benefits and charges taken into account
  - Statutory interest, mortality and expense assumptions
  - Follow contract structure
- Actuarial safeguards were built in to limit “manipulation” of plan designs
  - Limit investment orientation, not contract terms
Actuarial Elements

- Net premium is the mechanism by which the relationship between the cash value and net amount at risk is controlled
- Guideline, net single and 7-pay premiums:
  - Present expected value of net premiums = present expected value of benefits to be provided
- For level premium whole life coverage:
  - $A_x = P_x \times \dd{a}_x$

Cash Value Accumulation Test

- First alternative definitional 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
  - “By the terms of the contract”
  - Net single premium
  - Cash surrender value
“Terms of the Contract”

- CVAT compliance must be guaranteed “by the terms of the contract”
  - The CVAT is a prospective test that must be met at all times
  - It must be impossible for the cash surrender value to exceed the NSP under the contract’s mechanics
- A contract that would not meet the CVAT at some future date will be considered to have failed the test at issue

Net Single Premium

- Annual effective interest of 4% or, if greater, the rate or rates guaranteed on issuance of the contract
- For contracts entered into before October 21, 1988, the mortality charges specified in the contract
- For contracts entered into on or after October 21, 1988, “reasonable” mortality charges
- No expenses other than certain expenses for qualified additional benefits (“QABs”)
- IRC Section 7702(b)(2)(C) and (e) “computational rules” restrict the benefits that may be taken into account
Cash Surrender Value

- Net single premium is compared to the “cash surrender value” of a contract to determine whether the CVAT requirements are met for that contract
- “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”
Cash Surrender Value Definition

- Statute – IRC Section 7702(f)(2)(A)
- Legislative history
- Proposed regulation 1.7702-2
- Notice 93-37
- IRS letter rulings
- Return of premium
- Status of return of premium benefits and other non-insurance benefits payable or with value
- More to come .... (?)

Guideline Premium Test

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

- Annual effective interest of:
  - 6% (GSP) or 4% (GLP)
  - or, if greater, the rate or rates guaranteed on issuance of the contract

- Same mortality charge rules as NSP

- “Reasonable” expense charges (if specified)
  - “reasonably expected to be actually paid”

- Same IRC Section 7702(e) computational rules as NSP

Guideline Premium Limitation per $1,000 of Insurance

Assumptions: 2001 CSO Male Aggregate; 4% GLP; 6% GSP; Age 45
### Premiums Paid

- Premiums paid under the contract less:
  - Distributions that are not taxed
  - Excess premiums described by IRC Section 7702(f)(7)(B)
  - Force-out amounts returned (with interest) within 60 days of the end of a contract year
  - Other amounts specified in regulations
- May differ from “premiums paid” under IRC 72(e) “investment in the contract”
  - Examples – IRC Section 1035 exchanges; situations where 60 day or recapture rules apply

### Premiums Returned

- If a premium must be returned to comply with the guideline limitation, any “force-out” amount returned within 60 days after the end of a year will reduce the premiums paid during that year
  - Statute refers to the return of “any premium paid during any contract year”
  - The premium that is returned need not be an amount paid during the year in which it is returned
  - Interest must accompany amount being returned and is taxable (but it does not reduce premiums paid)
IRC Section 7702(d) Corridor Requirements

- Like the CVAT, the guideline premium test also has a minimum death benefit, or “corridor” requirement
  - “Corridor factors” are prescribed in IRC Section 7702(d)
- Relative to the CVAT, the minimum required death benefit under the guideline premium test is generally less
  - A “corridor death benefit” generally occurs later on a guideline plan than a CVAT plan.

Minimum Death Benefit per $1 of Cash Value
(Male Aggregate Mortality - Endowment @ 100)
Modified Endowment Contracts

- Defined in IRC Section 7702A(a)
- Entered into on or after June 21, 1988
- Life insurance contract within the meaning of IRC Section 7702
- Fails to meet the 7-pay test prescribed in IRC Section 7702A(b)
  - Or received in exchange for a modified endowment contract

MEC Distributions

- Pre-death distributions (e.g., policy loans, partial withdrawals and policyholder dividends) subject to more restrictive tax rules:
  - Annuity rules in IRC Section 72(e) apply – LIFO treatment of distributions, including loans and assignments
  - IRC Section 72(e)(4)(B) treatment is retained
  - Penalty tax under IRC Section 72(v) may apply
7-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

7-Pay Premium

- “Net” level annual premium needed to pay up the contract in 7 years; computation generally follows the CVAT rules
- Annual effective interest of 4% or, if greater, the rate or rates guaranteed on issuance of the contract
- For contracts entered into before October 21, 1988, the mortality charges specified in the contract
- For contracts entered into on or after October 21, 1988, “reasonable” mortality charges
- Generally no expenses other than certain expenses for QABs may be taken into account
MEC Miscellany

- Computational rules under IRC Sections 7702A(c)(1) and 7702(e) restrict the benefits that may be taken into account.
- 7-pay premium is increased by $75:
  - Initial death benefit of $10,000 or less
  - Require payment of at least 7 nondecreasing premiums
- Modal premium:
  - Reg. authority never exercised
- Aggregation rule:
  - All MECs issued by the same insurance company to the same policyholder in the same calendar year are to be treated as one contract (an anti-abuse rule) under IRC Section 72(e)

Part II:
Computing the IRC Section 7702 and 7702A Limitations: Methods and Assumptions

Life Insurance and Modified Endowments
Under IRC Sections 7702 and 7702A
Calculation Methods

- Methods by which actuarial values are to be computed are not specified
- Two principal methods that are commonly applied to the calculation of values:
  - Basic actuarial principles (including the use of commutation functions)
  - Projection-based (or illustration system) approach

Basic Principles

- Basic techniques of actuarial mathematics for defining insurance premiums
  - Fundamental relationship that equates the present value of future premiums with the present value of future benefits and expenses (and other charges)
- Flexibility for accommodating unique product designs and contract features
  - Contract adjustments under IRC Section 7702 using the attained age increment and decrement method (as described generally by Senators Dole and Bentsen)
Projection Method

- Simulates the monthly contract mechanics:
  - Guideline premiums or NSPs = premiums that mature the contract on the assumed maturity date using the required actuarial assumptions and future benefits
- Iterative process:
  - Crediting premium to a policy account, to which interest is credited and from which mortality and other expense charges are deducted

Processing Frequency

- Refers to the time interval over which discrete policy level events are assumed to occur
- Does not affect the interval over which premiums are assumed payable for purposes of computing the GLP and the 7-pay premium
  - Guideline level and 7-pay premiums are defined by IRC Sections 7702 and 7702A as level annual amounts
Actuarial Assumptions

- Restrictions on actuarial assumptions (mortality, interest and expense) are key elements in developing the definitional limitations.
- Contract provisions and guarantees form the basis of the actuarial assumptions:
  - Statutory restrictions are imposed, with differences depending upon the issue date of the contract.
  - Intended to restrict the ability of product designers to increase the definitional limits artificially, through manipulation of the assumptions.

Statutory Interest Rates

- Interest rates are the greater of the statutory rates or the rate or rates guaranteed upon issuance of a contract.
- Statutory Rates:
  - Net single premium: 4%
  - Guideline single premium: 6%
  - Guideline level premium: 4%
  - Seven-pay premium: 4%
Initial Interest Guarantees

- Initial credited rate exceeding the guaranteed minimum rate (or floor rate) is considered a part of the rate guaranteed upon issuance
  - Reflected for the duration of the initial guarantee period
- Short-term guarantees (extending no more than one year)
  - *De minimis* in guideline level premium
  - Not in guideline single premium, the net single premium or the 7-pay premium
- Bonus interest and similar amounts

Post-issue Guarantees

- Interest crediting guarantees lasting up to 12 months which come into effect after a policy’s issue usually are not “interest rate guarantees” (PLR 199929028)
- “One can reasonably infer that the drafters of section 101(f) may have viewed excess interest credits that vary from year to year as economically equivalent to policyholder dividends” (PLR 9723040)
  - “One also might reasonably infer that the annual declaration of an excess interest rate should not have any effect on a contract’s guideline premium limitation”
CVAT Interest Rates

- The statutory rates may serve to impose an indirect limitation on traditional whole life.
  - The CVAT must be met by the terms of the contract
- As the cash value cannot, at any time, exceed the NSP computed at 4% interest.
  - A CVAT contract assuming an interest rate lower than 4% could not meet this requirement at the time that the contract became paid-up, and would then fail the test at issue.

CVAT Interest Rates, cont.

- For CVAT contracts,
  - SNFL defines minimum required cash surrender value based on maximum prescribed interest rates– the “floor”
  - IRC Section 7702 defines maximum permissible cash surrender values based on the interest rate (or rates) guaranteed in the contract – the “ceiling”
- What happens when the ceiling falls below the floor?
CVAT Interest Rates, cont.

- The SNFL maximum interest rate is based on the statutory valuation rate, which is tied to the Moody’s Corporate Average
  - A continued decline in interest rates increases the possibility that the SNFL maximum interest could exceed the IRC Section 7702 minimum interest rate
    - Impact on traditional life insurance under the CVAT

CVAT Interest Rates, cont.

- Potential solutions
  - Impose a floor on the SNFL interest rate
  - Modify IRC Section 7702
    - An unlikely candidate given the risk associated with any legislative change to IRC Section 7702
  - Delink the SNFL interest rate from the valuation rate
Mortality: Pre-TAMRA

- IRC Section 101(f)
  - “Mortality and other charges guaranteed under the contract”

- IRC Section 7702
  - “Entered into” before October 21, 1988
  - “Mortality charges specified in the contract (or, if none are specified, the mortality charges used in determining the statutory reserves for such contract)”

  - “Specified in the contract” generally interpreted as guaranteed mortality rates

“Reasonable” Mortality

- TAMRA imposed restrictions on mortality and expense charge assumptions used in computing definitional limits under IRC Section 7702 and 7702A for contracts issued on or after 10/21/88

- The reasonable mortality requirements imposed on contracts under IRC Section 7702(c)(3)(B)(i) can be viewed as having both a permanent mortality rule and an interim mortality rule
Permanent Mortality Rule

- Statutory requirements specified in IRC Section 7702(c)(3)(B)(i)
  - 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
  - 2001 CSO is now the most recent standard table prescribed by the NAIC
    - Prevailing table in July 2004
    - Three year transition rule applies whenever table changes

Interim Mortality Rule

- Interim rule for contracts issued on or after October 21, 1988, but before the effective date of final regulations
  - Section 5011(c)(2) of TAMRA
  - Final regulations have yet to be issued on reasonable mortality
    - The interim rule is the currently operative rule for substandard risks
  - Reasonable 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
Proposed Regulation Sec. 1.7702-1

- General rule (Section 1.7702-1(a)): Mortality charges are “reasonable mortality charges” if they do not exceed the lesser of (1) the charges described by Section 1.7702-1(b), or (2) the mortality charges specified in the contract.

- Section 1.7702-1(b):
  - Defined reasonable mortality
  - “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”

Proposed Regulation Sec. 1.7702-1 (cont.)

- Safe harbors
  - 1980 CSO for single life contracts
  - Unisex safe harbor
  - 1958 CSO safe harbor for certain pre-1989 contracts

- Rules for substandard and non-participating contracts

- Proposed regulation never finalized
IRS Issued Guidance on Reasonable Mortality

- Notice 88-128
- Notice 2004-61
  - Replaced by Notice 2006-95
- Notice 2006-95
  - Supplements Notice 88-128
  - Supersedes and replaces Notice 2004-61

Notice 88-128

- TAMRA permanent and interim rules create questions
- Notice 88-128 applies to contracts issued on or after October 21, 1988
- Provides that use of certain safe harbor mortality tables will satisfy the requirements of IRC Section 7702(c)(3)(B)(i)
  - The safe harbor mortality table for contracts entered into after October 20, 1988 is 100% of the sex distinct 1980 CSO Tables (consistent with its specification as the prevailing commissioners' table)
  - Limited safe harbor for use of 1958 CSO (certain contracts issued before 1/1/89 that are non-MECs)
**Notice 2006-95: 2001 CSO**

- IRS Notice 2006-95 provides additional “safe harbors”
  - 1980 CSO safe harbor
    - 1980 CSO is reasonable
    - Applies to contracts issued before 2009
  - 2001 CSO safe harbor
    - The lower of 2001 CSO or contract guarantee is reasonable
    - Applies to contracts issued:
      - Before 2009 in a state that permits 2001 CSO
      - On and after 1/1/2009

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**CSO Table Adoption Process**

- 2001 CSO Adoption Process
  - Adoption was by regulation, so tracking state adoption was feasible
  - Regulations provided for a multi-year transition period before its use was mandated
    - Period of continued use of prior tables
    - Sunset date when use of new tables was mandated (1/1/2009)
  - States took a certain amount of time to adopt the regulation, allowing IRS, Treasury and the insurance industry to address tax related issues –
    - 2001 CSO Table as reasonable mortality and material change rules (Notice 2006-95)
    - Coordination of transition period to 2001 CSO for IRC Section 7702 purposes (SOA Taxation Section Maturity Age Task Force, Notice 2009-47 and Revenue Procedure 2010-38)
CSO Table Adoption Process (cont.)

- With VM-20, new CSO tables will be adopted through the valuation manual without the traditional state adoption process
  - Accelerates the transition period
  - May not provide adequate time to resolve tax issues with IRS & Treasury

CSO Table Adoption Process (cont.)

- Recent Guidance Note was adopted for transition rules to new CSO table
  - Permitted for use starting 1/1 following second calendar year following adoption
  - Optional use until 1/1 of 5th calendar year following adoption and mandatory thereafter
  - Conforms to IRC Section 807(d)(5)(B) transition period
    - Provides consistent transition for statutory and tax reserving
Substandard Mortality

- Before the imposition of the reasonable mortality rules, mortality charges were based on the contractually guaranteed rates (i.e., the mortality rates specified in the contract).
- The treatment of substandard mortality was relatively straightforward – use the mortality guaranteed in the contract.

Substandard Post TAMRA

- Created a great deal of uncertainty
  - Variations exist in how companies reflect substandard mortality.
  - TAMRA interim rule takes "into account any relevant characteristic of the insured of which the company is aware"
    - May imply that a company must have some underwriting basis for expecting that its actual mortality charges will exceed standard mortality charges.
Limited Guidance

- IRS Notices exclude any discussion relating to substandard contracts
- Proposed Regulation Section 1.7702-1 permitted the mortality charges to exceed the prevailing tables if the insurance company actually expected to impose those higher charges
  - No allowable mortality margin incorporated into the calculations
  - Generally inconsistent with the manner in which reasonable mortality applies to a standard risk contract

Methods for Reflecting Substandard Mortality

- Multiplicative
  - Substandard rating applied to the reasonable mortality applicable to a standard contract
- Additive
  - The amount necessary to maintain the same margin between guaranteed and current mortality charges as that applicable for a standard risk contract
- Current
  - Mortality charges that exceed reasonable mortality charges, but only to the extent of expected actual charges
Final Regulation on Age

- Regulation Section 1.7702.2
- Can determine by birthday ("actual age")
- Can determine by reference to contract anniversaries, staying within 12 months of actual age
- However done, apply consistently throughout 7702
- Applies only for certain purposes under the statute – GLP calculation, cash value corridor, and computational rules
- Relationship to IRC Section 7702A material change rule?

Final Regulation on Age (cont.)

- Multi-Life Contracts:
  - For last-to-die contracts, the only relevant age is that of the youngest insured
  - For first-to-die contracts, the only relevant age is that of the oldest insured
  - Regulations prohibit use of a “blended” or derived age (such as joint equal age) for maturity date or IRC Section 7702(d) cash value corridor
Final Regulation on Age (cont.)

- Effective Dates:
  - Takes into account transition period for adoption of the 2001 CSO
  - Applies to contracts:
    - Issued after December 31, 2008, or
    - Issued on or after October 1, 2007 and based upon the 2001 CSO

Expense Charges

- Parallels exist in the legislative history regarding the treatment of expense charges and mortality charges in both IRC Section 101(f) and IRC Section 7702
  - For contracts issued prior to October 21, 1988, there was no expressed statutory limitation on expense charges (unlike the statutory limitation imposed on interest rates)
  - Like mortality, companies were permitted to use “the maximum [expense] charges guaranteed at issue for the life of the contract”
Reasonable Expense Charges

- For contracts entered into on or after October 21, 1988, the guideline premiums must be computed assuming “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”

- Rule also applies to QABs under the CVAT as well as the GPT and the 7-pay test

Defining “Reasonable”

- There are no actuarial standards that could be applied to determine whether the expense loads on a contract are reasonable

- Any test applied would be in the manner of a facts and circumstances analysis

- Regulations have yet to address reasonable expenses, leaving open various interpretations of the terms reasonable and reasonably expected to be paid
Part III: Future Benefits, Death Benefits and Qualified Additional Benefits

Life Insurance and Modified Endowments Under IRC Sections 7702 and 7702A

Computational Rules

- Restrictions on the benefits assumed to be funded are also key to the operation of the definitional limits
- The computational rules in IRC Section 7702(e) restrict both the timing and magnitude of benefits that may be assumed in the determination of values
- Using the assumed interest, mortality and benefits, actuarial mathematics defines the net single premium as the discounted present value of future benefits (apart from the special rule for QABs, expenses are not allowed in the NSP)
IRC Section 7702(e)(1)(A) - Death Benefits

- The death benefit used in computing the guideline premiums or NSP is generally assumed not to increase
- Reflects the benefits in the contract, but only as limited by this computational rule
  - Contractually decreasing death benefits seemingly should be reflected in the computations at issue
  - The presence of IRC Section 7702(e)(1)(C) renders this conclusion somewhat uncertain

IRC Section 7702(e)(1)(B) – Maturity Date

- The maturity date assumed in the calculations must be between attained ages 95 and 100
  - Historically, this coincided with the terminal age of the mortality tables (1958 CSO & 1980 CSO)
    - Noted specifically in legislative history
  - Adoption of the 2001 CSO (terminal age 121) created a tension with IRC Section 7702(e)(1)(B)
2001 CSO Maturity Date Issues

- The 2001 CSO Tables end at age 121
- How should the IRC Section 7702/7702A limits be calculated beyond age 100?
  - Might the cash value corridor be extended to 121?
  - Might the IRC Section 7702(e)(1)(B) maturity date be extended to age 121?
- IRS issued Notice 2009-47 and Revenue Procedure 2010-28 to address these and other questions

Revenue Procedure 2010-28

- Addresses a number of post age 100 issues
  - Application of the IRC Section 7702 computational rules
  - Application of the statutory tests generally
  - Adjustments
- The Revenue Procedure provides a safe harbor
  - Eight requirements to the “Age 100 Testing Methodology”
  - Must satisfy ALL 8 requirements to meet the safe harbor
  - Emphasized that this is a safe harbor
- The Revenue Procedure made obsolete Notice 2009-47, which had proposed these safe harbors and had required that the death benefit be at least 105% of the cash value
Revenue Procedure 2010-28 (cont.)

- Contract must satisfy all of the “Age 100 Testing Methodologies”
  - Assume contract matures at age 100
  - CVAT and necessary premium test (“NPT”): NSP assumes endowment at age 100
  - GLP: Assume premium payments through age 99
  - Sum of GLP: Increase through a date no earlier than 95 / no later than 99
    - Testing continues thereafter, but SGLPs remains constant

Revenue Procedure 2010-28 (cont.)

- Age 100 Testing Methodologies (cont.)
  - Material Changes between ages 93 and 100
    - 7-pay is based on number of years remaining to age 100
    - Sum of 7-pay would increase to age 100
    - Sum of 7-pay remains constant after age 100 for remainder of 7-pay test.
  - Reductions in Benefit between ages 93 and 100
    - Rules continue to apply for the full 7 years (forever in the case of joint & survivor contracts)
  - Post age 100 adjustments / material changes
    - Not treated as a material change or an adjustment event
IRC Section 7702(e)(1)(C) – Deemed Benefits

- Death benefits are assumed to be provided until the “deemed” maturity date
  - Allows partial face endowments at ages before 95
  - Some have construed it to mean that contractually decreasing death benefits need not be reflected in the at-issue computations, but only need to be dealt with as the decreases occur

IRC Section 7702(e)(1)(D) – Endowment Benefit

- The amount of any endowment benefit (or sum of endowment benefits) taken into account cannot exceed the least amount payable as a death benefit at any time
  - Includes any cash surrender value on the deemed maturity date
  - For CVAT, this rule is tempered by treatment of the contract as newly issued whenever there is an adjustment (see IRC Section 7702(b)(2)(C) and the legislative history)
IRC Section 7702(e)(2)(A) - GLP “Relief”

- For the GLP, an increasing death benefit may be taken into account to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value (i.e., non-increasing risk)
  - The use of the IRC Section 7702(e)(2)(A) computational rule is not limited to an “option 2” (face plus cash value) death benefit, but may be applied to any increasing death benefit pattern, subject to the non-increasing risk rule

IRC Section 7702(e)(2)(B) – CVAT “Relief”

- The increase described in IRC Section 7702(e)(2)(A) may be taken into account “assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium”
  - This relief is not worth much
  - Unclear how to do adjustments here
Least Endowment Rule

- The IRC Section 7702(e)(2) rules do not provide relief from IRC Section 7702(e)(1)(D)
  - Limits the guaranteed funding for the endowment benefit to the least death benefit payable under the contract
- For a CVAT plan, the least endowment is computed based on the current death benefit
  - An increasing benefit can be provided (based on non-guaranteed factors), so long as the cash value does not exceed the NSP for the (then) current death benefit with associated endowment

Comparison with IRC Section 101(f) Rules

- As contrasted with IRC Section 7702, IRC Section 101(f):
  - Allowed GSP for option 2 benefits
  - Did not allow QABs under the CVAT
  - GLP must assume premiums for 20 years, or (if earlier) to age 95
- IRC Section 101(f) applied to all flexible premium contracts issued before January 1, 1985
TEFRA Blue Book Option 2 Example

<table>
<thead>
<tr>
<th>Specified Amount</th>
<th>Planned contract premium.</th>
</tr>
</thead>
<tbody>
<tr>
<td>100,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Premium</td>
<td>Premium less expense charge and initial cost of insurance</td>
</tr>
<tr>
<td>20,000</td>
<td>GSP</td>
</tr>
<tr>
<td>Initial Cash Value</td>
<td>17,524</td>
</tr>
</tbody>
</table>

| (1) | First Year Expense | 300.00 | 300.00 |
| (2) | Specified Amount   | 100,000 | 100,000 |
| (3) | PV $1.00 Death Benefit | 0.323638 | 0.680905 |
| (4) | (2) x (3)         | 32,363.80 | 68,090.50 |
| (5) | Endowment Amount  | 117,524 | 117,524 |
| (6) | Interest Factor   | 0.029212 | 0.089875 |
| (7) | (5) x (6)         | 3,433 | 10,562 |
| (8) | (1) + (4) + (7)   | 36,097 | 78,953 |
| (9) | Percent of Premium Load | 10% | 10% |
| (10) | (8) / [1 - (9)] | 40,108 | 87,726 |
| (11) | Annuity Factor   | 1,000.000 | 22,299.606 |
| (12) | (10) / (11)      | 40,108 | 3,934 |

7-Pay Computational Rules

- IRC Section 7702A also incorporates the IRC Section 7702(e)(1) computational rules with one exception
- The exception: IRC Section 7702A(c)(1)(B) requires that the death benefit provided for in the first contract year be assumed to be provided until the maturity date of the contract without regard to any scheduled reduction after the first seven contract years
  - Compare with IRC Section 7702(e)(1)(C) (death benefits assumed to continue until the deemed maturity date)
Reductions in the 1st 7 Years

- IRC Section 7702A(c)(2)(A) provides that if “benefits” under the contract are reduced during the first seven contract years, then IRC Section 7702A is applied as if the contract had originally been issued at the reduced benefit level
  - The calculation rules apply to scheduled and unscheduled benefit reductions in the first seven contract years
  - Effectively requires that scheduled reductions be reflected in determining the at-issue 7-pay premium
  - This rule also applied in the first 7 years following a material change

Qualified Additional Benefits

- Congress created the concept of QABs when it enacted IRC Section 101(f) in 1982
- Like the term “modified endowment,” the term “qualified additional benefit” has meaning outside of IRC Sections 101(f), 7702 & 7702A
- While the statute lists the QABs, their status as “additional benefits” casts light on the meaning and treatment of additional benefits which are not “qualified”
Qualified Additional Benefits

- The list is:
  - Guaranteed insurability
  - Accidental death or disability benefits
  - Family term coverage
  - Disability waiver benefit
  - Other benefits prescribed under regulations (none exist)

- Examples of non-QABs:
  - Long-term care & certain other accelerated death benefits
  - Term on non-family members (e.g., business partners)
  - Status of disability income riders?

QABs in IRC Section 101(f)

- Under IRC Section 101(f), the concept of a QAB only applied to the guideline premium limitation (i.e., it did not apply to the cash value test)
  - Did the presence of an additional benefit that was not a QAB disqualify the contract from treatment as life insurance under IRC Section 101(f)?

- The guideline single and level premiums reflected the charges for QABs (as “future benefits”) but not the QABs themselves
QABs in IRC Section 7702

- Both guideline premiums and the NSPs under the CVAT are computed by reference to the contract's “future benefits,” which includes charges for QABs that satisfy the applicable expense charge rule.
- The presence of an additional benefit that is not a QAB is permitted under IRC Sections 7702 and 7702A, but the definitional limitations are not increased to reflect the cost of the benefit.

Reasonable Mortality & QABs

- In private letter rulings (PLRs) the IRS addressed whether the reasonable mortality limitations or the reasonable expense limitations applied to QABs.
  - Some insurers erroneously reached two conclusions regarding QABs:
    1) “reasonable charges other than mortality charges” described in IRC Section 7702(c)(3)(B)(ii) referred only to expense loads, and
    2) cost of insurance charges for family term riders and other QABs were considered mortality charges under the reasonable mortality charge rule.
Revenue Ruling 2005-06

- Issued January 19, 2005
- Confirms position IRS had taken in PLRs
- QABs are subject to “reasonable expense charge rule” of IRC Section 7702(c)(3)(B)(ii), not the “reasonable mortality charge rule” of IRC Section 7702(c)(3)(B)(i)
- The Revenue Ruling provided a mechanism for avoiding compliance failure through a closing agreement with the IRS

Reflecting QABs in the GLP

- QAB charges may be amortized over the term of the QAB or over that of the contract
- According to the TEFRA “Blue Book” and the IRC Section 7702 legislative history:
  - In determining GLPs, the guideline premiums should reflect the charges over the period for which they are incurred (i.e., over the life of the QAB), thus avoiding post-funding of the benefits
  - Statute does not say this
  - Although the “bi-level” funding results in a higher initial guideline limitation, it results in a lower overall guideline limit
Riders under IRC Section 7702A

- The legislative history of IRC Section 7702A states that, for purposes of the 7-pay test, riders on a base contract are not tested separately but are to be “considered part of the base insurance contract for purposes of the 7-pay test”
- Questions arose regarding the meaning of this in the case of term coverage riders on the primary insured under the base contract, since that coverage is a QAB under IRC Section 7702

Term Rider on the Primary Insured: IRC Section 7702

- Under IRC Section 7702(e)(1)(C), death benefits are assumed payable to the deemed maturity date (between age 95 and 100)
  - Extending death benefit treatment to a term rider could incorporate death benefits into the calculation of the guideline premium limitation and NSP that are not provided by the contract
  - Since term rider on the primary insured is a QAB under IRC Section 7702, only the charges for the rider (not the death benefit) are reflected
Term Rider on the Primary Insured: IRC Section 7702A

- If “otherwise provided” in IRC Section 7702A, terms can have a different meaning in that statute than in IRC Section 7702 (per IRC Section 7702A(e)(3))

- PLRs – “Death benefit” for IRC Section 7702A purposes refers to life insurance coverage provided for more than 7 years and so can include term rider coverage on the primary insured lasting at least 7 years
  - PLRs 9513015 (Dec. 30, 1994) and 9519023 (Feb. 8, 1995)

Term Rider on the Primary Insured: Summary

- Always treated as a death benefit under IRC Section 7702A, provided that the coverage lasts at least 7 years

- Generally treated as a QAB under IRC Section 7702 except in the case where the rider continues to age 95 or later
  - Rider benefit is treated as a death benefit under both statutes if continued to at least age 95
  - PLRs 9513015 (Dec. 30, 1994), 9519023 (Feb. 8, 1995) and 9741046 (July 16, 1997)
Treatment of Non-QABs

- Conceptually, a contract with a non-QAB can be viewed as consisting of two elements: a life insurance contract and another contract.
- The actuarial limitations for both IRC Sections 7702 and 7702A are based on the life insurance contract only.
  - The existence of the non-QAB contract will have no effect on the guideline premiums, NSPs or 7-pay premiums of the life insurance contract.

Treatment of Non-QABs (cont.)

- Amounts taken from life contract to pay for the QAB are distributions.
- This has tax consequences – especially if the life contract is a MEC.
- Those distributions may reduce “premiums paid” and “amount paid” (i.e., to the same extent as any other distribution).
- See PLR 9106050.
Part IV: Computing the IRC Section 7702 and 7702A Limitations: Adjustments, Material Changes and Exchanges

Life Insurance and Modified Endowments Under IRC Sections 7702 and 7702A

Overview

- Adjustment Events under IRC Section 7702
  - Adjustment Methodology
- Policy Changes under IRC Section 7702A
  - Material Changes
  - Reduction in Benefits
  - Necessary Premium
- Effective Dates and Loss of Grandfathering
Adjustments

- IRC Section 7702
  - Adjustment rules allow for changes in benefits while maintaining definitional limitations

- IRC Section 7702A
  - Certain changes are defined as "material changes"
    - Starts a new 7-pay test
  - Other changes are characterized as "reductions in benefits"
    - May Modify 7-pay limit in existing test

IRC Section 101(f)

- The TEFRA Blue Book expands on the Dole-Bentsen colloquy

- Adjustments can occur:
  1) if the amount or pattern of a policy's benefits (including qualified additional benefits) is changed by the policyholder; or
  2) upon the occurrence of a change in benefits previously scheduled under the contract that could not be taken into account earlier because of the computational rules
IRC Section 7702

- IRC Section 7702(f)(7)(A) states: “If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under [IRC Section 7702], there shall be proper adjustments in future determinations made under [IRC Section 7702].”

CVAT Adjustments

- The CVAT requires that all benefit changes be taken into account under adjustment rules
- CVAT limit is equal to the NSP for future benefits computed using the IRC Section 7702 restrictions on assumed future benefits and actuarial assumptions and the insured’s age
  - Contract treated as newly issued
  - The CVAT has been described as “self-adjusting”
“New” Issue Date

- Adjustments under the CVAT are based on the future benefits at the time of the change
  - Unlike GPT, does not reflect level of benefits before the change
- The “new issue date” concept, together with the language of IRC Section 7702(b)(2)(C), enables adjustments under the CVAT to be reconciled with:
  - The deemed-not-to-increase rule of IRC Section 7702(e)(1)(A), and
  - The limitation on the final endowment value under IRC Section 7702(e)(1)(D)

Adjustments under the GPT

- An increase or decrease is treated separately from the existing guideline limits
  - Separate guideline premiums are computed to reflect the increase or decrease
- This method is outlined in the Dole-Bentsen colloquy, which introduced the attained-age increment/decrement method
  - Adjustment implemented using “before and after” calculations based on the attained age of the insured at the time of the change and reflecting the change in benefits
Dividends and Excess Interest

- Certain benefit changes are considered adjustment events under the CVAT but not the GPT:
  - Declarations of excess interest (as well as of reductions in “current” mortality or expense charges)
  - Benefit increases due to policyholder dividends
    - Takes a broad view (i.e., as in IRC Section 808) of the term “policyholder dividend”
- Important to distinguish guarantees from dividends

Benefit Reductions

- IRC Section 7702(f)(7)(B) initially provided that any change in the contract that reduced the future benefits was to be treated as an exchange of contracts
  - Money distributed would be treated as taxable “boot” under IRC Section 1031(b) (i.e., gain-first taxation)
- The rule was amended in 1986
  - The Blue Book for the technical corrections of the 1986 Tax Reform Act describes the attained age decrement method of adjusting guideline premium limitations in the event of a reduction in benefits
Decrease in Death Benefit

- Similar to that applied for increases in death benefits, except that the “after” calculation reflects a reduction in benefits
  - Certain types of benefit reductions can produce negative guideline single and/or level premiums
  - Negative guideline premiums do occur in practice and must be properly incorporated into the administration of contracts
  - A decrease in benefits can occur due to termination of a QAB, including by reason of the death of the insured under a family term rider

Criticisms of Attained-Age Method

- The adjustment rules do not create full parity between a policyholder who increases benefits under an existing contract and one who purchases a new contract
- If the decrease is large enough, the guideline premium limitation can become negative, throwing the operation of the test into question
- Contracts can become underfunded and the adjustment mechanism is inadequate to deal with this problem
  - IRC Section 7702(f)(6) is an option, but cumbersome
Adjustments under IRC Section 7702A

- Two adjustment rules, which are different from those under IRC Section 7702, apply to calculations under IRC Section 7702A
- Reductions in benefits that occur within the first seven years
  - A special reduction in benefits rule applies to survivorship products (i.e., second-to-die)
- Material changes

Reductions in Benefits

- If benefits under the contract are reduced during the first seven contract years, then under IRC Section 7702A (c)(2)(A), the stature is applied as if the contract had originally been issued at the reduced benefit level
- The new reduced limitation is applied to the cumulative amount paid under the contract for each of the first seven years
- The retroactive re-testing can cause a contract to become a MEC
Reductions in Benefits (cont.)

- If the re-testing gives rise to a MEC:
  - Distributions affected? Two-year rule
  - Year to tax report?
- Re-testing rule does not apply to a lapse due to nonpayment of premiums where a reinstatement is made within 90 days of the lapse (IRC Section 7702A(c)(2)(B) – a frequent source of problems)
- Does the re-testing rule apply when benefits are paid? What if contract is exchanged for one with lower benefits?

Material Changes

- When changes occur to a contract other than a reduction in benefits, the material change rule of IRC Section 7702A(c)(3) may apply
  - “Material change … in benefits [or] terms … not reflected in any previous determination…”
- The material change rule applies throughout the life of a contract
  - It does not cease applying after a contract passes through a 7-pay testing period without becoming a MEC
Material Changes (cont.)

- “Material Change” includes change in contract terms and any increase in the death benefit or any increase in, or addition of, a QAB

- However, a material change does not include death benefit increases “attributable” to “necessary premiums” and interest / earnings thereon. Due to this necessary premium test (“NPT”), one must distinguish between:
  - A “material change event” (i.e., the first bullet above which describes events that would be material changes but for application of the NPT)
  - A “material change” (i.e., the point in time when a material change is recognized under IRC Section 7702A)

Material Changes (cont.)

- Exceptions:
  - Any increase which is attributable to the payment of a necessary premium (more to come)
  - To the extent provided in regulations, any COLA increase (with conditions)
    - Must be based on an established broad-based index
    - Must be funded ratably over the remaining premium paying period
    - No regulations to date, and none expected (i.e., provision is inoperative)
Material Changes (cont.)

- Upon the occurrence of a material change, the contract is treated for purposes of IRC Section 7702A as a new contract entered into on the day the material change takes effect.
- The contract is be tested from that point forward, over the ensuing 7 years, to determine whether it will meet a new 7-pay test.
- The calculations for the materially changed contract are based on the future benefits then provided by the contract and the insured’s then attained age (comparable to a newly issued contract).

Rollover Rule

- A “rollover rule” applies to account for any cash surrender value existing at the time of the materials change.
- The otherwise computed 7-pay premium for the post-change contract is reduced to account for this.
- The reduction of each premium = the pre-existing cash value (disregarding any surrender charge) divided by a 7-year payout annuity factor.
Necessary Premiums

- An exception to the material change rules applicable to an increase in future benefits
  - An increase in future benefits may not result in a material change if the increase is attributable to the payment of necessary premiums and interest / earnings thereon

- Necessary premium is the premium required under the contract guarantees to fund the lowest future benefit during the initial seven contract years (or for seven years following a material change)
  - Manner for implementing differs between GPT and CVAT contracts

Necessary Premiums (cont.)

- General rule: recognition of a benefit increase as a material change “may” be deferred if there is no unnecessary premium in the contract
  - Option under OBRA 1989 legislative history
  - May choose instead to apply the statute’s “attributable” standard more strictly

- If so deferred, a material change must be recognized at the time unnecessary premium is paid into the contract
Effect of Necessary Premiums

- Import of option: an increase in death benefit resulting from the payment of a premium in excess of the necessary premium limit can result in the application of the material change rule either directly at the time the premium is paid or at a later time.

- Where material changes were previously deferred and then “unnecessary premium” is paid, a material change will be triggered, even if the prior deferred material changes only arose due to non-guaranteed elements in the contract (such as the crediting of dividends to purchase PUAs or from corridor increases).

Grandfather – IRC 7702

- A change after 1984 to a contract “issued” before January 1, 1985, often will cause the contract to become subject to IRC Section 7702. However, a change will not cause a contract to be treated as newly “issued” if:
  - The change does not affect the material terms or economics of the contract, *i.e.*, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges.
Grandfather – Reasonable Charge Rules and Notice 2006-95

- TAMRA effective date rule for application of reasonable mortality and expense charge rules – based on “entered into” date of a contract

- Notice 2006-95 – What would cause an existing contract to be treated as newly issued and subject to the 2001 CSO mortality requirements?

- Notice provides safe harbors, but limits their application based on their “issue date”

Grandfather – Notice 2006-95

- § 5.01 of the Notice – IRC Section 7702 grandfather standard

- § 5.02 of the Notice – A change will not result in new “issue” treatment in the case of:
  - A change, modification or exercise of a right to modify, add or delete benefits pursuant to the terms of the contract
  - State does not require use of 2001 CSO
  - Contract continues on the same policy form or blank

- Examples provided in § 5.03:
  - Add / remove rider or QAB
  - Increase / decrease death benefit (or change DB option)
  - Reinstate with 90 days of lapse
  - Change a rating on a policy

- Examples must be read together with the § 5.02 rule
Application of the Notice: PLR 201230009

- Material change / grandfather issue is not new for the industry
- Asking for clarification was risky
- In PLR 201230009 (Jan. 30, 2013), taxpayer asked if death benefit reduction lost 1980 CSO grandfathering under the Notice where policyholder did not have right to demand it
- IRS ruled that grandfather was lost

Effective Date – IRC Section 7702A

- Generally applies to contracts “entered into” on or after June 21, 1988
- Contracts issued prior to June 21, 1988 can become subject to the IRC Section 7702A requirements under certain circumstances:
  - If the death benefit increases by more than $150,000 over its October 20, 1988 level (subsequent to IRC Section 7702A(c)(3) material change rule) even if a policyholder had a unilateral right to the increase
  - Any benefit increase or QAB increase to which the policyholder did not have a unilateral right (without underwriting) prior to June 21, 1988
  - A term conversion
Administering Policy Changes

- Contract changes commonly give rise to compliance issues
- On-going compliance with IRC Section 7702 and 7702A is a dynamic process
  - Automated procedures are a necessity, but human oversight is critical

Types of Policy Changes

- Company initiated changes
  - Challenging as “transactions” may not be created within the administration system to trigger processing
- Policyholder initiated changes
  - Typically requires additional “controls”
  - New products/plan codes typically created to deal with changes in rules or assumption eras (more on this later)
- Changes occurring under the normal operation of the contact
Administering Policy Changes

- Two critical elements for compliance with the material/policy change rules
  - Understanding what changes can be made under particular contracts and the company’s position on how changes should be treated for tax purposes (“business rules”)
  - Understanding how the administration system is handling material changes (“administrative rules”)
- Is there consistency between the business rules and the administrative rules?
- Is the appropriate administrative data available for the calculation?

Impact of Material Changes under IRC Section 7702

- Effective date of IRC Section 7702 – The statute generally applies to contracts “issued” after December 31, 1984

- Changes to pre-DEFRA contracts – What changes can cause a contract to be treated as newly “issued,” causing IRC Section 7702 to apply in the first instance?
Impact of Material Changes under IRC Section 7702 (cont.)

- Changes to Contracts Already Subject to IRC Section 7702 –
  - Use the adjustment rule of IRC Section 7702(f)(7)(A) as governing the treatment of changes “in the benefits under (or in other terms of) the contract”?
  - Are there circumstances where changes should cause a contract to be newly “issued” so that IRC Section 7702 is applied wholly anew?

- TAMRA’s Reasonable Mortality and Expense Charge Rules – These rules were incorporated into IRC Section 7702 in 1988 and generally apply to contracts “entered into” on and after October 21, 1988

Impact of Material Changes under IRC Section 7702A

- Effective Date of Code § 7702A - The statute generally applies to contracts “entered into” on or after June 21, 1988. When should changes to a pre-TAMRA contract cause it to be newly “entered into”?

- Special statutory effective date rules -
  - See prior slide
  - Implications for the meaning of “entered into” otherwise
Policyholder administration systems determine the actuarial limitations used to measure compliance.

- Actuarial limitations are based on:
  - Rules - A particular set of tax rules (or tests) that restrict the investment orientation of the contract
  - Assumptions - A particular set of actuarial assumptions (e.g., interest, mortality and expenses) used in determining the actuarial limits

- Tax rules and requirements around actuarial assumptions used to calculate the actuarial limitations have changed over time.

### Rule and Assumption Era Timeline

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Material Changes, Effective Date Rules and Policy Adjustments

- What effect do policy changes have on the rule era and assumption era applicable to a contract?
- Will depend in part on:
  - The existing rule and assumption era
  - The type of policy change
  - Contract terms and guarantees
- Lack of authoritative guidance creates challenges
- Policyholder administrative systems necessarily adopt positions on each legal question with regard to all policy changes

Concluding Thoughts

- The tax law regarding material changes may be colored in differing shades of gray, but policyholder administration systems necessarily are colored in black and white (i.e., they are rules based)
- Keys to successfully administering material changes:
  - Understand your products
  - Understand the differing rules and assumptions eras
  - Stay current on emerging guidance (e.g., PLR 201230009)
  - Document your “business rules”
  - Ensure consistency between business rules and administrative practice
  - Ongoing assessment of business rules and administrative practice is essential
Part V: Managing Product Tax Risk

Life Insurance and Modified Endowments Under IRC Sections 7702 and 7702A

Managing Product Tax Risk

- Insurance companies are charged with administering products within the requirements of the Internal Revenue Code
- An effective Product Tax Compliance operation requires:
  - An understanding of the qualification rules applicable to life insurance contract
  - Insurance products be properly designed to conform to the qualification requirements
  - Policyholder administration assist in the ongoing monitoring of compliance
    - Includes the proper withholding and reporting of income
Sources of non-compliance

- How are qualification failures detected?
  - Generally no IRS audit program
  - Short answer – often, someone goes looking for them
    - Sale due diligence (subsidiary, block of business)
    - System conversion, new personnel
    - Something anomalous will be detected and investigation reveals problems

- Why do IRC Section 7702/7702A qualifications failures occur?
  - Complexity of rules
  - Misunderstanding of the qualification requirements
  - Lack of tax professional oversight
  - State law interpretation/actuarial practice vs. tax law interpretation, (e.g., no “tolerances”)

Sources of non-compliance, cont.

- Why do IRC Section 7702/7702A qualifications failures occur (continued)?
  - Product design errors - Many product innovations and features raise tax questions. Some examples:
    - Return of premium benefits (cash value definition and interest and mortality guarantees implicit in product)
    - Short term guarantees or features that may affect interest or mortality guarantees (e.g., bonus interest and no lapse features)
    - Alternative cash values
    - Guaranteed withdrawal benefits
    - Interaction with additional benefits, such as accelerated death benefits payable upon critical illness
    - Strategies for reacting to low interest rate environment
  - Administrative errors in the ongoing monitoring for compliance
  - IRS issuance of new guidance
Sources of non-compliance, cont.

- Additional sources of non-compliance for variable contracts:
  - Failure to monitor diversification (many examples)
  - Mistaken application of Treasury / government agency investment rules – see, e.g., Notice 2000-9
  - Legal uncertainty (derivatives, stable value wraps, etc.)
  - Mistakes in understanding rules or in assessing risk in connection with the investor control doctrine (e.g., Rev. Rul. 2003-92)

Consequences of non-compliance

- IRC Section 7702/7702A qualification failures
  - Exposes insurer’s tax reporting errors and penalties
    - Qualification status sets forth reporting requirements
      - Differs for a IRC Section 7702 compliant and failed contract
      - Differs for MECs and non-MECs
  - Cost of remediation (contracts and systems) can be substantial
  - Reputational risk & policyholder dissatisfaction
    - Potential claims, lawsuits by policyholders
    - Damage to brand name and agent relations
  - FIN 48 reserve
  - Disclosure to auditor
Remediation of Qualification Failures

- Life Insurance – Remediation
    - Closing agreement to “un-MEC” an inadvertent MEC
    - Closing agreement to remediate failed contracts
    - Limited IRC Section 7702 relief at limited cost
  - Rev. Proc. 2008-42
    - IRC Section 7702(f)(8) auto waiver
    - Full IRC Section 7702(g) closing agreement
- Administrative system remediation
  - Costs can be substantial
- Discussion with IRS audit team?
- What about “self help”?

Risk Mitigation Strategies

- Educate senior officers about risks and costs of non-compliance
- Upgrade – and verify – compliance software
- Continuing education for all
  - Improve staff training
  - Educational sessions on the basic tax law requirements
  - Staying current on emerging product tax issues
- Documentation of existing methodology, assumptions, interpretations, opinions, etc.
- Assigning ownership of tax compliance
  - Needs to involve legal, actuarial, IT and others
Risk Mitigation Strategies, cont.

- Involve “product tax” in the all aspects of the product life cycle
  - Product development
  - Policy issuance
  - Post issue changes
  - Pre-death distribution
  - Claims payment
- If it can be automated, it should be automated
  - Need to differentiate between “automated” and “auto-pilot”

QUESTIONS?

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