# Southwest Actuaries Club

Product tax update
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## Session overview

- Managing product tax risk
- Recent private letter rulings (PLR):
  - PLR 201230009 – treatment of death benefit reductions
  - PLR 201137008 – application of the necessary premium test (NPT) for cash value accumulation tested (CVAT) contracts
- Definition of cash surrender value under Section 7702
- Potential implications under Section 7702 in a low interest rate environment
- Proposed regulations regarding qualified longevity annuity contracts (QLACs)

## 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 each type of insurance contract
  - Proper design of insurance products to conform to the qualification requirements
  - Policyholder administration assist in the ongoing monitoring of compliance
    - Including the proper withholding and reporting of income



## Managing product tax risk (cont'd)

- How are qualification failures detected?
  - Generally no Internal Revenue Service (IRS) audit program
  - Short answer — someone goes looking for them
    - Sale due diligence (subsidiary, block of business)
    - System conversion, new personnel, other
- Why do qualification failures occur?
  - Complexity of rules
  - Misunderstanding of the qualification requirements
  - Lack of tax professional oversight
  - State law interpretation/actuarial practice versus tax law interpretation, (e.g., no tolerances)
  - Product design errors
  - Administrative errors in the ongoing monitoring for compliance
  - IRS issuance of new guidance

## Managing product tax risk (continued)

- Implications of qualification failures
  - Cost of remediation (contracts and systems) can be substantial
  - Exposes insurer's tax reporting errors and penalties
  - Reputational risk and policyholder dissatisfaction
  - Disclosure to auditor



## Managing product tax risk (continued)

- Key elements of managing product tax risk:
  - Understanding the rules
  - Understanding your company's products
  - Understanding the systems on which each product is administered
  - Staying current and informed on product tax issues

# Material changes: private letter ruling under Sections 7702 and 7702A



## Death benefit reduction: PLR 201230009 (January 30, 2012)

- Background
  - Notice 2006-95 provided safe harbor rules for mortality assumptions for Sections 7702 and 7702A, including continued use of 1980 Commissioners Standard Ordinary (CSO) mortality (grandfather)
  - Notice §5.01 — Transition rules in the Deficit Reduction Act of 1984 (DEFRA) legislative history treating contract changes as exchanges apply to determine if change maintains or loses 1980 CSO grandfather
  - Notice §5.02 — Also, change pursuant to right in contract maintains 1980 CSO grandfather

## Death benefit reduction (continued)

- PLR 201230009 (January 30, 2012)
  - IRS was asked about maintaining 1980 CSO grandfather if death benefit is reduced at policyholder request, absent explicit right in contract
  - Citing Notice §5.02 rule and absent the explicit right in the contract to obtain a reduction, IRS held that 1980 CSO grandfathering was lost
- Industry implications of the PLR
  - Any inconsistencies between contract language and the historic administration of policies could lead to inadvertent modified endowment contracts (MECs) under Section 7702A and failed contracts under Section 7702



## Death benefit reduction (continued)

- The American Council of Life Insurers (ACLI) has asked the IRS to reconsider this ruling position, arguing that Notice §5.01 and special rule in DEFRA legislative history should govern:
  - DEFRA legislative history said that death benefit reductions are not treated as exchanges for purposes of transition rules
  - Accordingly, under Notice §5.01 death benefit reductions do not lose 1980 CSO grandfather, whether or not based on contractual right; rule in Notice §5.02 not relevant
- Current status

# Necessary premium test (NPT) ruling




## Use of expense charges in "necessary premiums" for CVAT contracts

- PLR 201137008 (June 14, 2011)
- Under Section 7702A(c)(3), material change (new contract) treatment does not apply to benefit change "attributable" to "necessary premiums"
- Necessary premiums: basically, premiums needed to fund lowest benefits under contract in seven-year testing period

## Use of expense charges in necessary premiums (continued)

- According to the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) Conference Report, for CVAT contracts: (net) premium is necessary so long as it does not exceed difference between (1) attained age NSP for lowest death benefit during the seven year testing period and (2) lesser of contract's "deemed cash surrender value" or its actual cash surrender value (CSV)
- Deemed CSV = value based on guaranteed interest rate less certain mortality and expense charges; described in legislative history



## Use of expense charges in necessary premiums (continued)

- In PLR, IRS was asked whether expenses charged against account value in CVAT-based universal life contract reduced deemed CSV in determining necessary premiums
- Expenses were represented to be reasonable under Section 7702(c)(3)(B)(ii) rule
- IRS held that expenses reduced deemed CSV, looking to Section 7702A legislative history
- See February 2012 article in *Taxing Times*

# What is Section 7702 cash surrender value?



## Defining cash value

- Statutory definitions
  - Legislative history
- Proposed regulations
- Letter rulings
- Guidance plan

## Cash surrender value defined

- Section 7702(f)(2)(A): "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 is a necessary element of compliance with Section 7702
  - Cash value accumulation test
  - Section 7702(d) cash value corridor



## 1984 legislative history

- Any amount to which the policyholder is entitled upon surrender *and*, generally, against which the policyholder can borrow
- Determined without regard to any surrender charge, policy loan or reasonable termination dividend
- Excludes amounts returned under credit life insurance policies (because amount is not subject to borrowing)

## Proposed Treas. Reg. 1.7702-2

- Cash value of a contract is the greater of:
  - Maximum amount payable under the contract (determined without regard to any surrender charge or policy loan)

  Or
  - Maximum amount that the policyholder can borrow under the contract
- Amounts excluded from cash value
  - Death benefit and qualified additional benefits
  - Other benefits
  - Amounts returned on termination of credit life
  - Reasonable termination dividends not exceeding $35 per $1,000



## Return of premium/cash value enhancements, Section 7702 treatment

- Question —How should the return of premium/cash value enhancement be treated under Section 7702?
- Five private letter rulings address the issue:
  - PLR 200521009 (waiver request)
  - PLR 200528018 (waiver request)
  - PLR 200745006
  - PLR 200841034 (waiver request)
  - PLR 200901028 (waiver request)

## Return of premium/cash value enhancement features

- No borrowing permitted against enhancement in the private letter rulings
- All rulings held: enhancement is included in the contract's Section 7702 "cash surrender value"
- IRS granted all waiver requests —insurers were required to remediate failed contracts



## Uncertainty of interest rate assumptions under Sections 7702 & 7702A

## Low interest rate environment

- We are in a historically low interest rate environment
- Federal Reserve's main tool for stimulating the economy is interest rates
- Fed has pledged it would keep short-term rates near zero until at least the end of 2014
- SF Fed Bank president said open to extend Fed's low-rate pledge into 2015



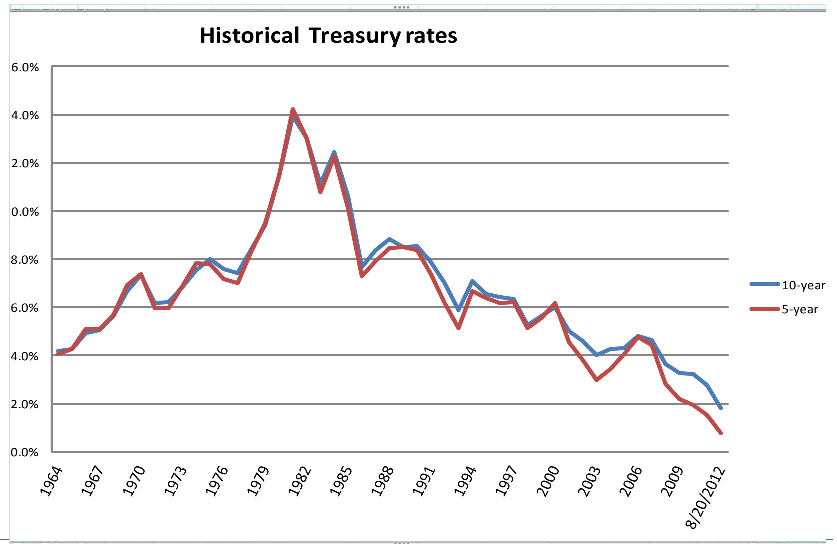
## Sections 7702 and 7702A restrictions on interest rates

- Greater of the rate or rates guaranteed on issuance and minimum prescribed rates
  - CVAT 4%
  - Guideline level premium (GLP) 4%
  - Guideline single premium (GSP) 6%

To place in historical perspective

| | 1984 | August 20, 2012 |
|---|---|---|
| 10-year Treasuries | 12.5% | 1.8% |
| 5-year Treasuries | 12.3% | 0.8% |

## Historical 5- and 10-year Treasury rates






## If Section 7702 minimum rates are greater than contract's guaranteed rates

- Universal life (UL) – tested using CVAT
  - Can comply with Section 7702 if guaranteed rate in contract is less than 4%
  - Death benefit = greater of original face amount and cash value divided by NSP
  - NSP calculated using 4%

## If Section 7702 minimum rates are greater than contract's guaranteed rates

- UL – tested using guideline premium test
  - Can comply with Section 7702 if guaranteed rate in contract is less than 4%
  - Issue: policyholder could pay maximum GLP, and contract could run out of value before the end of the mortality table
  - Section 7702(f)(6) – a contract can still comply with Section 7702 if a premium is paid that results in the premiums paid exceeding the guideline premium limitation if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will not have any cash value at the end of such period)



## If Section 7702 minimum rates are greater than contract's guaranteed rates (cont'd)

- Traditional whole life – tested using CVAT
  - Fails as of the date of issue
  - If contract could ever become paid up (e.g., fully paid up by its term; reduced paid up)
    - Section 7702 maximum cash value = NSP @ 4%
    - State minimum cash value = NSP @ 3.75%
    - This is true even if the 7702 limit is based on an endowment at age 100 and the state minimum is based on an endowment at age 121
      - Male – non smoker
        - NSP @ 4% for endowment at age 100 is less than NSP @ 3.75% for endowment at age 121 until age 94 (continuous and curtate)

## Possibility of maximum non-forfeiture rate less than 4%

- Maximum non-forfeiture rate = 125% of maximum valuation rate
- Maximum valuation rate cannot be less than 3%
- If maximum valuation rate is 3%, then maximum non-forfeiture rate will be 3.75%
- Maximum valuation rates
  - 2012 4.00%
  - 2013 3.50%
  - Must change by at least one half percent
  - If 2013 maximum valuation rate had been 3.25%, the industry would not be looking at the possibility of an issue in near future



## When could the maximum valuation rate drop to 3%?

- July 2012 Moody's 4.03%
- If Moody's stays level at 4.03%, then the maximum valuation rate will stay at 3.5%
- If Moody's drops 6 basis points per month from August 2012 through June 2013
  - 2014 maximum valuation rate will be 3%
  - 2014 maximum non-forfeiture rate will be 3.75%
  - 2014 issues could continue to use the 2013 maximum non-forfeiture rate of 4.5%
  - Solution would be needed for 2015 issues
- Fed has pledged it would keep short-term rates near zero until at least the end of 2014

# Longevity insurance: QLACs



## Longevity insurance: QLACs

- What is longevity insurance?
  - Conditional deferred payout annuity (CDA)
  - Payments commence later in life (e.g., age 85)
  - Typically no cash value
    - Must survive to annuity starting date
  - Limited (if any) death benefit
  - Idea = lower-cost way to insure tail risk

## Longevity insurance: QLACs (cont'd)

- Proposed regulations address required minimum distributions (RMDs) issue:
  - IRC §401(a)(9) RMDs
  - Must commence distributions by required beginning date
  - Entire interest must be reflected in calculation
  - Longevity insurance typically has no cash value
  - Could produce value that must be distributed but no liquidity
  - Would mean other assets drawn down more rapidly
  - Possible RMD failure (50% excise tax) or qualification failure if insufficient other assets



## Longevity insurance: QLACs (cont'd)

- How do the proposed regulations address the problem?
  - Define qualifying longevity annuity contract, or QLAC
  - Value of QLAC not part of entire interest in account
  - Means RMDs determined without regard to QLAC
    - Only the other assets are considered in making RMD calculation
    - QLAC's presence will not accelerate RMDs for other assets
    - QLAC's lack of liquidity will not risk RMD failure

## Longevity insurance: QLACs (cont'd)

- How is a QLAC defined?
  - Commercial, fixed annuity
  - States that it's intended to be a QLAC
  - Premium limits
    - Lesser of 25% of account balance or US $100k
  - Annuity starting date must occur by age 85
  - No cash value, commutation right or similar benefit
  - Payments must meet RMD rules (e.g., non-increasing)
  - Death benefits limited to life-contingent survivor annuities



## Any questions?

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