Managing life insurance product tax risk

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Session overview

- Present an overview of the Internal revenue Code (IRC) qualification rules for life insurance
- Discuss sources of noncompliance
- Highlight the implications for noncompliance
- Discuss strategies to mitigate the risk of noncompliance

Managing life insurance product tax risk

- Insurance companies are charged with administering products within the requirements of the IRC
- An effective product tax compliance operation requires:
  - An understanding of the qualification rules applicable to each product
  - Design of products to properly conform to the qualification requirements
  - Administration of policies according to the requirements of 7702 and 7702A
    - Includes the proper withholding and reporting of income
  - Ongoing training to maintain current knowledge
  - Oversight at an appropriate level

Life Insurance – qualification rules

- IRC Section 7702
  - Defines a life insurance contract for purposes of the IRC
  - Limits the allowable cash value and/or premiums paid
  - Compliance allows for:
    - Tax deferral of “inside build-up”
    - Tax-free receipt of death benefit
  - Two available tests for compliance
    - Guideline premium test
      - Limits the amount of premium that can be paid into a policy
      - Minimum death benefit requirement
    - Cash value accumulation test
      - No specific premium requirement
      - Minimum death benefit requirement

Life Insurance – qualification rules

- Guideline premium test, IRC Section 7702(c)
  - A policy will comply with this section if it meets these two requirements:
    - The premiums paid do not exceed the maximum of the guideline single premium or the sum of the guideline level premiums
    - The policy's face amount must exceed the cash value multiplied by a percentage based on the insured's attained age.

Life Insurance – qualification rules

- Guideline premium test, IRC Section 7702(c)
  - The guideline premium limitation at any point in time is the maximum of the guideline single premium, or the sum of the guideline level premiums.
  - Guideline premium calculations reflect:
    - Mortality charges (subject to reasonable mortality rules post 10/20/1988)
    - Policy expenses (subject to reasonable expense rules post 10/20/1988)
    - Charges for qualified additional benefits (subject to reasonable expense rules post 10/20/1988)
    - Guideline single premium
      - Single premium to endow at age not greater than 100
      - 6% interest rate (or the policy guaranteed rate, if higher)
    - Sum of guideline level premiums
      - Annual level premium to endow at age not greater than 100
      - 4% interest rate (or the policy guaranteed rate, if higher)
  - Section 7702(d) cash value corridor
    - The policy's death benefit must always be greater than or equal to the policy's cash value multiplied by the applicable percentage prescribed in this section.

Life Insurance – qualification rules

- Cash value accumulation test, IRC Section 7702(b)
  - A policy will comply with this section if its cash surrender value does not at any time exceed the net single premium that would fund future benefits.
    - To stay in compliance, the policy's death benefit will be increased if the policy's cash value exceeds the net single premium for the initial face amount.
    - Net single premium calculation reflects:
      - 4% interest rate (or the policy guaranteed rate, if higher)
      - Mortality charges (subject to reasonable mortality rules post 10/20/1988)
      - Charges for qualified additional benefits (subject to reasonable expense rules post 10/20/1988)
      - Excludes policy expenses

Life Insurance – qualification rules

- Qualified additional benefit – defined in Section 7702(f)(5)(A)
  - Disability waiver benefit
  - Guaranteed insurability
  - Accidental death or disability
  - Family term coverage
  - Other benefits prescribed under regulations

Life Insurance – qualification rules

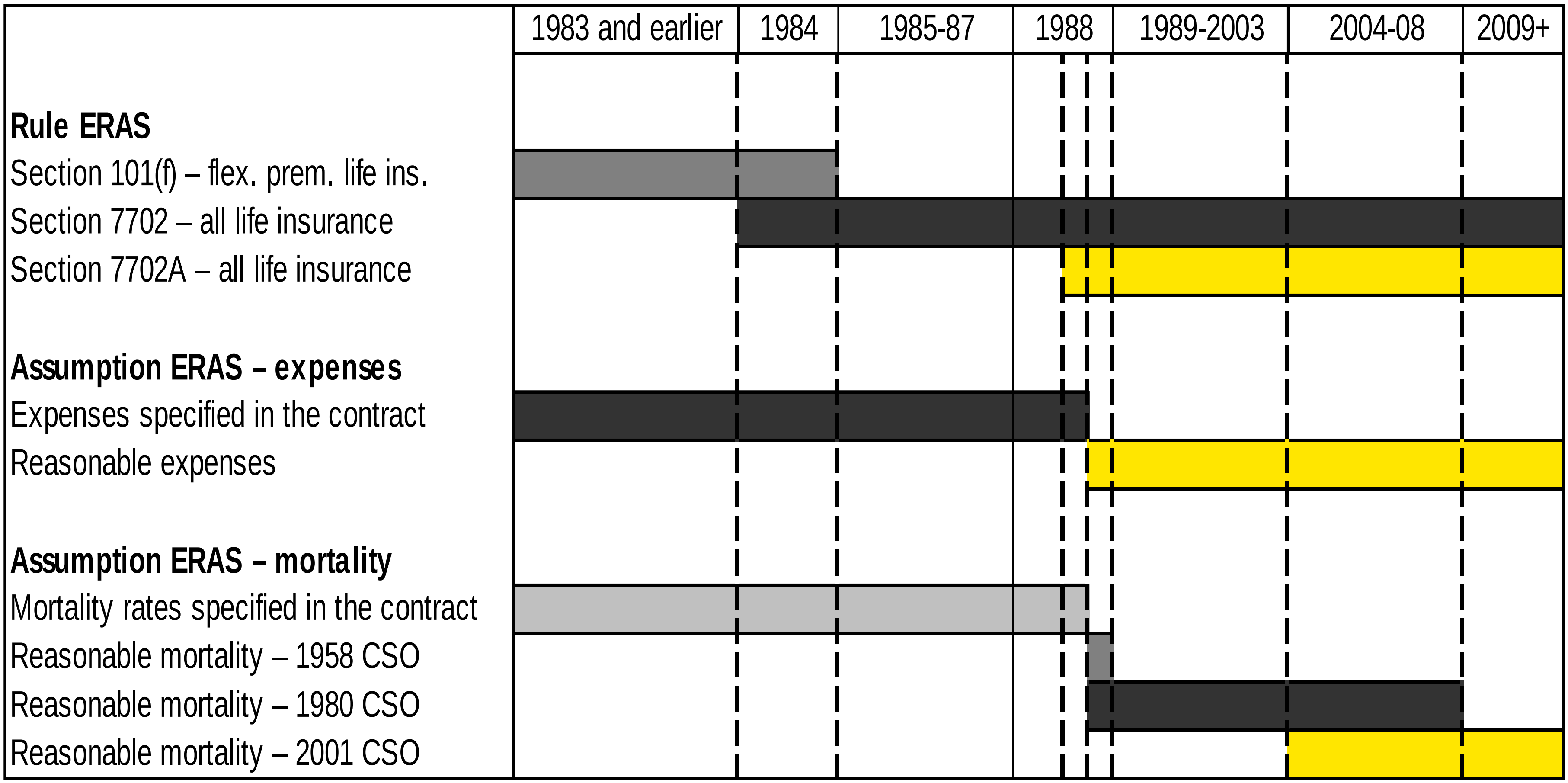
- IRC Section 7702A
  - Imposes a premium limitation on contracts to avoid becoming a modified endowment contract (MEC)
  - Implications of becoming a MEC
    - Still a qualifying life insurance contract under section 7702
    - Subjects pre-death distributions (including loans) to taxation under the annuity rules
  - 7-Pay Premium
    - Premium limitation during first seven years of a contract
    - 4% interest rate (or the policy guaranteed rate, if higher)
    - Reasonable mortality charges
    - Charges for qualified additional benefits (subject to reasonable mortality rules post 10/20/1988)
    - Excludes policy expenses

Life Insurance – qualification rules

- Actuarial qualification requirements are complex!
  - Guideline Premium Test (GPT) adjustments
  - Qualification of riders
  - 7-Pay Test, material change, reduction in benefits
  - Changes to regulations over time

Life Insurance – qualification rules

- Chart of time frames and changes to tax law



- Given all the complexity involved, how is compliance maintained?

Managing life insurance product tax risk

Managing life insurance product tax risk

- Why do qualification failures occur?
  - Misunderstanding of the qualification requirements
  - Product design errors
  - Administrative errors in the ongoing monitoring for compliance
  - Internal Revenue Service (IRS) issuance of new guidance
  - Lack of tax professional oversight

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- How are qualification failures detected?
  - Generally no IRS audit program
  - Short answer -- someone goes looking for them
    - Sale due diligence (subsidiary, block of business)
    - System conversion / system consolidation
    - New personnel, e.g., CRO, Chief Actuary

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- Implication of qualification failures and costs of noncompliance:
  - Cost of remediation can be substantial
    - Policy level remediation
    - System remediation
  - Reporting and withholding requirements (Rev. Rul. 91-17)
  - Reputational risk and policyholder dissatisfaction
  - Disclosure to auditor
  - Potential claims, lawsuits by policyholders
  - Damage to brand name and agent relations

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- Consequences and costs of non-compliance:
  - Section 7702 failure
    - Loss of tax deferral or exemption on inside buildup
    - Tax on prior and future “income on the contract”
    - Withholding and reporting requirements
  - Section 7702A failure (creation of a MEC)
    - Unfavorable tax treatment of loans and withdrawals
    - Penalty tax application

Life insurance – remediation

- Policy remediation
  - Rev. Proc. 2008-39
    - Closing agreement to “un-MEC” an inadvertent MEC
  - Rev. Proc. 2008-40
    - Closing agreement to remediate failed contracts
    - Limited Section 7702 relief at limited cost
  - Rev. Proc. 2008-42
    - Section 7702(f)(8) auto waiver
- Administrative system remediation
  - Costs can be substantial
- What about “self-help”?

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- A program for avoiding noncompliance:
  - Educate senior officers about risks and costs of noncompliance
  - Make compliance a part of the overall enterprise risk management (ERM) program
  - Include tax professionals in product and system design, oversight
  - Upgrade and verify compliance software
    - Policy administration system
    - New business/in-force policy illustration system
  - Improve staff training
  - Provide continuing education for all
  - Document existing methodology, assumptions, interpretations, opinions, etc.
  - Assign ownership of tax compliance

Questions?

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