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

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| Assumption ERAS – expenses         |                  |      |         |      |           |         |       |
| Expenses specified in the contract |                  |      |         |      |           |         |       |
| Reasonable expenses                |                  |      |         |      |           |         |       |

| Assumption ERAS – mortality        |                  |      |         |      |           |         |       |
| Mortality rates specified in the contract |                  |      |         |      |           |         |       |
| Reasonable mortality – 1958 CSO    |                  |      |         |      |           |         |       |
| Reasonable mortality – 1980 CSO    |                  |      |         |      |           |         |       |
| Reasonable mortality – 2001 CSO    |                  |      |         |      |           |         |       |

Given all the complexity involved, how is compliance maintained?
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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
    - Closing agreement to “un-MEC” an inadvertent MEC
    - 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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