KCI Koehler Consulting, Inc.

KCI Tax Interpretation

Sample

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This document contains a sample sub-section from the KCI Tax Interpretation. This is for evaluation purposes, only. The table of contents of the entire document is available on our web site – www.koehlerconsult.com.

Guideline Premium Testing

Description

The Deficit Reduction Act of 1984 provided for the first time a statutory definition of life insurance. Life insurance contracts issued after 1984 must qualify as life insurance by meeting the requirements of one of two tests. One test is the Guideline Premium Test and the other is the Cash Value Accumulation Test. The Guideline Premium Test is comprised of two components.

The first component limits the amount of premium that can be paid into a life insurance policy over the life of the policy. This is called the Guideline Premium Requirement. The second component is the Cash Value Corridor Requirement. This test requires that the death benefit of a policy be increased when excessive levels of cash value accumulate relative to the insurance risk.

Unlike the Cash Value Accumulation Test, the Guideline Premium Test is a retrospective test under which a contract is assumed to be in compliance until an actual failure occurs. Therefore, a guideline premium contract will initially be in compliance, even if by its terms it will ultimately fail. In addition, a contract can fail and later be brought back into compliance by returning the excess premium payments within 60 days of the end of the Policy Year.

The Guideline test is seen as better suited to Universal Life and other flexible insurance products, where the contract values are not fixed at issue.

Intent

Congress was concerned in the early eighties with the growing number of investment oriented life insurance contracts and the favorable tax treatment that they received. Many of these contracts allowed a large amount of cash value to accumulate with a relatively small insurance risk. Section 7702 of the Deficit Reduction Act of 1984 addressed the potential abuse of these contracts by imposing restrictions on the amount of premiums that can be paid into a policy and the amount of cash value that can accumulate relative to the amount of risk.

Detailed Specifications

Section 7702, (c) (1)
When Testing Is Performed

The test must be met for the entire life of the contract in order for it to continue to qualify as life insurance. The Guideline Premium Test must be performed whenever a premium is paid. In the Tax System, the test will be performed on each transaction that is passed to the KCI Tax Server™.

When the Test Is Met

A contract is considered to have met the Guideline Premium Requirement if the sum of the Premiums Paid under the contract does not at any time exceed the greater of the Guideline Single Premium or the sum of the Guideline Level Premiums to date. In addition, the Death Benefit may not at any time be less than the applicable percent of the Cash Surrender Value.

When the Test is Failed

If a contract at any time does not meet the Definition of Life Insurance, the income on the contract for any taxable year will be treated as ordinary income received or accrued by the policyholder in that year.

The Tax System will identify any contract which fails the Definition of Life Insurance and the date on which the failure occurs. The contract will remain in a failed status until action is taken to bring the contract back into compliance.

Grandfather Status

Section 7702 subjects contracts issued after December 31, 1984 to the Definition of Life Insurance requirements and contracts issued prior to that date are generally exempt. There are certain instances in which changes to contracts issued before this date may subject them to the definitional requirements.

If a contract is exchanged after December 31, 1984, the existing contract must meet the requirements of the Section 7702 rules. Therefore, a contract issued before Section 7702 will lose its grandfather status as the result of a 1035 Exchange, even though the basis of the old contract is carried over to the new contract for determining the taxable gain upon surrender.

A change to a contract issued prior to January 1, 1985 may also bring the contract under the Section 7702 rules. The grandfather status will only be preserved if the terms of the resulting contract are fundamentally unchanged. The terms of the contract relate to the pattern of death benefits, the rates guaranteed at issue and the mortality and expense charges. This would mean that a death benefit increase on a contract issued before Section 7702 could bring it under the definitional rules, unless the right to increase the death benefit was specifically granted in the contract when it was issued.

Guideline Single Premium

The Guideline Single Premium is the single premium required at issue to fund the future benefits under the contract, based on assumptions set forth in the Internal Revenue Code. The following will be taken into account when calculating the Guideline Single Premium:

- The Mortality Charges that are specified in the contract or the charges used in determining the statutory reserves for the contract if not specified.
- Substandard Charges specified in the contract.
- Charges specified in the contract for Expenses.
- Charges specified in the contract for Supplemental Benefits.
- Interest at an annual rate of 6% or the rate guaranteed when the contract is issued.

Guideline Level Premium

The Guideline Level Premium is the level annual premium required at issue to fund the future benefits of the contract over its lifetime based on the assumptions set forth in the Internal Revenue Code and not ending before the insured reaches age 95. Computation of the Guideline Level Premium is made on the same basis as that for the Guideline Single Premium, except that the statutory interest rate is 4%.

Cash Value Corridor

A contract meets the requirements of the Cash Value Corridor if the death benefit under the contract at any time is greater than the applicable percentage of the cash surrender value. The corridor percentages apply to the attained age of the insured at the beginning of the year and are set forth in a statutory table. The percentages decrease as the age of the insured increases.

The corridor is intended to limit the build-up of cash value relative to the insurance risk present, although to a lesser degree than the Cash Value Accumulation Test. This is due to the limitation on premiums under the Guideline Premium Limitation.

Qualified Additional Benefits

Qualified Additional Benefits are not treated as future benefits under the contract, but charges for the future benefits, including substandard charges, will be treated as future benefits. In determining Guideline Level Premiums, the charges for these benefits should be reflected over the period during which they are incurred.

Certain insured YRT riders may be classified as a DEFRA Qualified Additional Benefit only if they terminate before the insured attained age 95. These are noted below.

The following are possible Qualified Additional Benefits:

- Disability Benefit
- Disability Waiver of Charges
- Children's Insurance Benefit
- Accidental Death Benefit
- Insured Term
- Spouse Term

If the future charges are not known until they are actually taken, a present value calculation would not be possible, yielding no QAB Credit.

Other Additional Benefits

Riders that are treated as a separate contract receives no credit in for the purposes of tax calculations.

Premiums Paid

Premiums Paid is a running total of money flowing into and out of the contract and is used for Guideline Premium Testing. The amount must not exceed the Guideline Premium Limit if the policy is to satisfy the Definition of Life Insurance. Premiums Paid is set to zero when the policy is issued, is increased when payments are made into the policy and is decreased by certain distributions from the policy. Premiums Paid may become negative in the case of large distributions from the policy.

Premiums Paid is tracked for the life of contract and is not reset to zero when an Adjustment to the contract occurs. The Premiums Paid with respect to Guideline Premium Testing are generally defined as:

1. The Premiums Paid under the contract, less
2. Withdrawals that are not taxable under section 72(e), less
3. Withdrawals that are taxable but are considered return of premiums under section 7702.

Premiums Paid under the contract include the gross premiums paid by the policyholder for the base policy and any riders, including any charges for substandard. The formulas will adjust the Guideline Premiums to compensate for the Premium Expenses that are taken out of each premium payment. This approach will allow the Guideline Premium Test to compare the gross premiums paid to the guideline premium limit that is calculated by the formulas.

Premiums Paid do not include amounts returned to the policyholder within 60 days of the end of a policy year with interest. Also, the contract will not be disqualified if a payment that exceeds the Guideline Limitation is necessary to prevent termination of the contract for no value on or before the end of the year. Transferred Cash Value resulting from a 1035 Exchange is included in Premiums Paid for Defra purposes.

Amounts Paid into the Contract	**Effect on Running Total**
Premiums Paid for Base Policy, Riders and Substandard	Add Full Amount
Premiums Waived Under Disability	None
Premiums Paid by Loan (APL or Other)	Add Full Amount
Pay Loan Interest or Repay Loan Principal	None
Non-Premium Cash Payment to Effect a Policy Change	Add Full Amount
Non-Premium Cash Payment to Effect a Reinstatement	Add Full Amount
Incoming 1035 Exchange Money Applied to New Contract	Add Full Amount
Term Conversion Credit Applied to New Contract	None

Amounts that are distributed from the contract generally will reduce the Premiums Paid running total. Amounts distributed under a life insurance contract are not taxable to the policyholder until they exceed the premiums paid in. An exception to the cost recovery rule is made when amounts are forced out under the Recapture Ceiling Rules because an adjustment to the future benefits has occurred.

For example, assume that a contract experiences an Adjustment due to a reduction. The new Guideline Premium Limit is $10,000 and the Premiums Paid is $12,000. The Premiums Paid will be reduced by $2,000 when the excess is forced out of the contract.

Amounts Distributed	**Effect on Running Total**
Force Out due to a Reduction in Benefits	Subtract the excess (if any) of the Premiums Paid minus the new Guideline Premium Limit
Full Surrender of Policy With or Without Loans	Subtract Portion Not Taxable. Loan amount is considered repaid, before amounts surrendered.
Reduction of Face Amount With or Without Loans	Subtract Portion Not Taxable
Lapse for RPU With No Loans	None

Amounts Distributed	**Effect on Running Total**
Lapse for RPU With Loans	Subtract Portion Not Taxable
Lapse for Extended Term With No Loans	None
Lapse for Extended Term With Loans	Subtract Portion Not Taxable
Outgoing 1035 Exchange With No Loan	None
Outgoing 1035 Exchange With Loan	Subtract Loan Amount Not Taxed
Return of Premium Payment Within 60 Days	Subtract Full Amount.
Withdrawal	Subtract Non-taxable portion of the distribution.
Partial surrender	Subtract non-taxable portion of the distribution. (Any loan repaid as part of this event is ignored. That is, the full amount removed from the policy is considered the distribution regardless of what the policyholder received).
Taxable amount resulting from 2 year lookback	None
Monthly process	Amounts paid will not increase if there is a taxable amount as a result of this event.

Anatomy of a Guideline Premium

In simple terms, Guideline Premiums represent the present value at interest and mortality of the sum of charges for the death benefit, substandard premiums, supplemental benefits and expenses. The Guideline Single Premium reflects the present value of these future charges as a single amount at issue. The Guideline Level Premium is the present value of these future charges spread as a level amount over the lifetime of the policy, but not ending before insured age 95.

The TAMRA legislation which was passed in 1988 placed a limitation on unreasonable mortality and expense charges. The law specifies that the expense charges that are used in the calculation of guideline premiums be reasonable and are the charges that are expected to be actually paid. The law also specifies that mortality charges will be considered reasonable if the charges do not differ materially from the charges actually expected to be imposed by the company.

The basic components of the Guideline Premium are broken down as follows:

1. **Interest** - Guideline Single Premium interest is at an annual rate of 6%, or the rate guaranteed under the contract if higher. Guideline Level Premium interest is at an annual rate of 4%, or the rate guaranteed under the contract if higher.
2. **Mortality Charges** - This will include mortality charges for the Death Benefit, assuming that the Death Benefit remains level for all years.
3. **Substandard Charges** - This will include the substandard charges associated with the Base Policy and any applicable riders.
4. **Expense Charges** - This will include premium expense charges and maintenance charges. Maintenance Charges are the same as Account Value Charges for the purposes of this document.
5. **Supplemental Benefits** - This will include the sum of the charges for each Qualified Additional Benefit for the period they will be in effect.

Mortality Charges

The Net Single Premium is determined for components of the contract that are classified as Death Benefits. This will include the Base Policy and any Insured Term Riders scheduled to continue to at least age 95.

Level Death Benefits

For contracts with level death benefit options, the Net Single Premium per dollar is multiplied by the Death Benefit and by the Uniform Distribution of Death factor that spreads deaths evenly over the course of a year. This factor is 1.0297807 for Guideline Single Premiums and 1.0198693 for Guideline Level Premiums.

The Net Single Premium will be determined by multiplying the appropriate Discount Rate by the probability of living n-1 years and dying in the current year. The formula for determining the Net Single Premium (NSP) for a Level Death Benefit is:

$$NSP = \left(v \times q_1 \times {}_{n-1}\, p_x + v^2 \times q_2 \times {}_{2-1}p_x + v^3 \times q_3 \times {}_{3-1}p_x + \ldots + v^n \times q_n \times {}_{n-1}p_x\right)$$