

KCI

Koehler Consulting, Inc.

KCI Tax Interpretation

Variable, Universal, and Traditional Life Products

January 27, 2017

Table of Contents Only

www.koehlerconsult.com

TABLE OF CONTENTS

INTRODUCTION	11
PRODUCTS	11
BUSINESS EVENTS.....	11
EVENT TYPES	11
INTERNAL REVENUE CODE SECTIONS.....	13
CSO MORTALITY TABLES.....	13
TAX TESTING SEQUENCE.....	13
DESCRIPTION	13
DETAILED SPECIFICATIONS	14
<i>General rule</i>	14
<i>Testing Sequence</i>	14
SECTION 72(E).....	15
BACKGROUND	15
DESCRIPTION.....	15
FLOW OF MONEY IN AN INSURANCE CONTRACT	15
COST BASIS.....	17
DESCRIPTION.....	17
INTENT	17
DETAILED SPECIFICATIONS	17
<i>Cost Basis Impacts</i>	17
<i>Interest Sensitive Contracts</i>	19
<i>Charges</i>	20
<i>Sales Load / Premium Tax</i>	21
<i>Examples:</i>	21
<i>Disability Waiver</i>	22
<i>Waived Charges - Insufficient Fund Value</i>	22
<i>Monthly Processing's Impact on Cost Basis</i>	24
<i>Charges assessed on partial surrenders and/or withdrawals</i>	25
<i>Cost Basis for Traditional Life contracts</i>	26
ACCOUNTS.....	26
ACCUMULATION ACCOUNT	26
INTEREST PAID ON LATE PREMIUM	27
UNAPPLIED DIVIDEND ACCOUNT	27
UNEARNED PREMIUM ACCOUNT.....	27
UNAPPLIED PREMIUM ACCOUNT.....	27
SUSPENSE ACCOUNT	28
TAX INTERPRETATION FOR ACCOUNTS	28
REFERENCES.....	28
DIVIDENDS.....	29
DESCRIPTION	29
I.R.C REFERENCE	29
DETAILED SPECIFICATIONS	29

<i>Dividends Paid</i>	29
<i>Example</i>	29
<i>Dividend Options</i>	30
<i>Examples:</i>	31
TAXABLE GAINS	34
DESCRIPTION	34
INTENT	34
DETAILED SPECIFICATIONS	34
<i>Cost Basis</i>	34
<i>Cash Surrender Value</i>	34
<i>Cash surrender value – Traditional Life</i>	35
<i>Gain</i>	35
<i>Distributions Subject to Taxation</i>	36
<i>Tax Events</i>	36
<i>Taxable Gain Procedure</i>	37
1. Cost Recovery Method (FIFO)	37
2. Gain First Method (LIFO)	38
3. Cash rich contracts (7702(f)) Recapture Ceiling Rules	40
<i>Loans</i>	40
<i>Settlement Options</i>	40
<i>Taxable Gain Summary</i>	40
<i>Cost basis adjustment</i>	41
<i>Relationship to TAMRA Testing</i>	43
<i>10% Pre-mature Distribution penalty</i>	43
REFERENCES.....	44
WITHHOLDINGS	46
DESCRIPTION	46
DETAILED SPECIFICATIONS	46
<i>Overview</i>	46
<i>Detailed Processing Logic</i>	46
<i>Federal Withholding YTD</i>	49
<i>State Withholdings</i>	49
<i>State Withholding Example</i>	49
<i>Reportable Payment</i>	52
<i>Contract Owner's TIN</i>	52
<i>Missing TIN</i>	52
<i>When to Withhold</i>	53
<i>Amount to Withhold – Suggested Amount</i>	53
FILING REQUIREMENTS	54
DESCRIPTION	54
DETAILED SPECIFICATIONS	54
<i>1099-R</i>	54
<i>Sample 1099-R</i>	55
<i>Tax Reporting Year</i>	55
<i>Distribution Code</i>	55
<i>Aggregated Entries</i>	56
<i>Multiple 1099s for One Business Event</i>	56
END OF YEAR TAX REPORTING	57
BACKGROUND	57
DETAILED SPECIFICATIONS	57
<i>End of Year</i>	57

<i>Examples, from the database perspective.....</i>	57
Example 1 – Taxable event detected which spans tax years.....	57
Example 2 – Taxable event reversed, spanning tax years.....	59
<i>Subsequent correction</i>	59
<i>Conversion.....</i>	60
<i>Additional System Behavior.....</i>	60
<i>KCI Tax Server Logic</i>	60
<i>Additional KCI Tax Server Fields</i>	62
<i>KCI Tax Server Parameters</i>	64
<i>Alerts.....</i>	64
DEFRA	65
DESCRIPTION.....	65
INTENT	65
DETAILED SPECIFICATIONS	65
REFERENCES.....	65
GUIDELINE PREMIUM TESTING.....	66
DESCRIPTION.....	66
INTENT	66
DETAILED SPECIFICATIONS	66
<i>When Testing Is Performed</i>	66
<i>Grandfather Status</i>	67
<i>Guideline Single Premium.....</i>	68
<i>Guideline Level Premium</i>	68
<i>Cash Value Corridor</i>	68
<i>Qualified Additional Benefits</i>	68
<i>Premiums Paid</i>	69
<i>Amounts Paid into the Contract</i>	70
<i>Anatomy of a Guideline Premium</i>	71
<i>Mortality Charges.....</i>	72
<i>Level Death Benefits.....</i>	72
<i>Variable Death Benefits.....</i>	72
<i>Substandard Charges</i>	73
<i>Expense Charges</i>	73
<i>Adjustments.....</i>	75
<i>Old Expense Charges, Old QAB Charges, Old Rating Charges.....</i>	80
<i>New Expense Charges, New QAB Charges, New Rating Charges.....</i>	80
<i>Present Value of the Old Level Death Benefit</i>	80
<i>Present Value of the Old Variable Death Benefit.....</i>	81
For normal Base Policy type contracts with possibly insured term riders	81
<i>Present Value of the New Level Death Benefit.....</i>	81
For normal Base Policy type contracts with possibly insured term riders	81
<i>Present Value of the New Variable Death Benefit.....</i>	82
For normal Base Policy type contracts with possibly insured term riders	82
For complex Base Policy type contracts (Total Sum Insured).....	82
<i>Present Value of Old Expense Charges, Old QAB Charges, Old Rating Charges</i>	82
<i>Level Death Benefit Option Contracts.....</i>	82
<i>Present Value of New Expense Charges, New QAB Charges, New Rating Charges</i>	83
<i>Level Death Benefit Option Contracts.....</i>	83
<i>Guideline Level Premium Adjustment Example for Level Death Benefit Option</i>	83
The Numerator.....	83
The Denominator.....	84
The New Guideline Level Premium	84
<i>Death Benefit Option Changes</i>	85
<i>Necessary Premium for Guideline Tested Products</i>	87

Level Term Riders.....	96
Non-Level Term Rider Decreasing Term.....	97
Non-Level Term Riders - Increasing, PCRR, etc.	97
Approach to Guideline Premium Calculations.....	99
Projection Data Requirements for Adjustments	100
Projection Data Examples – Qualified Additional Benefits	101
Spouse Level Term Rider.....	101
Off-Anniversary Adjustments.....	102
Guideline Premium Calculation Tables for formula driven contracts	102
Actuarial Values Used in the Formulas.....	104
Determination of Rider and Rating Charges.....	105
Procedures for Handling DEFRA Failures.....	105
Guideline Level Premium Calculation at Issue –Example	106
Assemble the Guideline Premium Less than Target	107
Guideline Single Premium Calculation at Issue – another Example	108
Assemble the Guideline Single Premium.....	109
Guideline Single Premium Calculation at Issue –Example.....	109
Assemble the Guideline Single Premium.....	111
DATA REQUIREMENTS.....	112
Tax Message, Tax Reply Message, Tax Database.....	112
REFERENCES.....	113
CASH VALUE ACCUMULATION TESTING	114
DESCRIPTION.....	114
INTENT	114
DETAILED SPECIFICATIONS	114
Timing of Tests	114
Cash Value Accumulation Test.....	114
IRC DEFRA Death Benefit.....	115
Death Benefit Factor	115
Cash Surrender Value	115
DEFRA Death Benefit Under the Contract	115
Total DEFRA Death Benefit Under the Contract.....	116
Corridor Death Benefit Under the Contract	116
DEFRA Death Benefit	116
Total DEFRA Death Benefit.....	117
Example 1:.....	117
DEFRA Issues.....	119
REFERENCES.....	119
RECAPTURE CEILING -- 7702(F)(7).....	120
DESCRIPTION.....	120
INTENT	120
DETAILED SPECIFICATIONS	120
Applicable Period.....	121
Cash Surrender Value	122
DEFRA Net Single Premium	123
Total DEFRA Death Benefit	123
Maximum Cash Surrender Value (a.k.a. GPT Cash Value Corridor).....	123
For Guideline Tested policies, the rules are:	124
Taxable Amount under Recapture Ceiling Rules.....	125
Effect on Other Attributes.....	125
Examples:	126
REFERENCES.....	126
TAMRA	127

BACKGROUND	127
DESCRIPTION.....	127
INTENT	127
DETAILED SPECIFICATIONS	127
<i>Testing Sequence</i>	127
REFERENCES.....	128
MEC CLASSIFICATION	129
DESCRIPTION.....	129
DETAILED SPECIFICATIONS	129
<i>Revocable v. Irrevocable</i>	129
<i>Removal of excess</i>	129
<i>MEC Status Reversal</i>	131
<i>Two Year Lookback</i>	131
<i>MEC Aggregation</i>	131
TWO YEAR LOOKBACK.....	133
BACKGROUND	133
DESCRIPTION.....	133
INTENT	133
DETAILED SPECIFICATIONS	133
<i>Recharacterization Period</i>	133
<i>Recharacterization Procedure</i>	133
<i>Going Forward</i>	136
7-PAY TEST	137
DESCRIPTION.....	137
INTENT	137
DETAILED SPECIFICATIONS	137
<i>7-Pay Testing Period</i>	137
<i>Business Events to Test</i>	138
<i>7-Pay Test</i>	138
<i>Accumulated 7-Pay Premiums</i>	139
<i>7-Pay Premium</i>	139
<i>TAMRA Death Benefits</i>	140
<i>7-Pay Premium for Death Benefits</i>	140
<i>7-Pay Premium Factor</i>	142
<i>Factor Determination</i>	143
<i>7-Pay Premium Factor - Calculated</i>	144
<i>TAMRA Low Death Benefit</i>	146
<i>TAMRA Death Benefit</i>	148
<i>Substandard Credit for the Death Benefits</i>	150
<i>Qualified Additional Benefits (QAB Credits)</i>	164
<i>Off-Anniversary Material Changes</i>	167
<i>QABs to Include</i>	168
<i>7-Pay Annuity Factor</i>	174
<i>Other Additional Benefits</i>	174
<i>7-Pay Premium Calculation After a Material Change</i>	175
<i>7-Pay Annuitized Cash Value</i>	175
<i>7-Pay Premium Calculation After an Incoming 1035 Exchange</i>	176
<i>7-Pay Premium Adjustment</i>	176
<i>Accumulated Amounts Paid</i>	177
<i>Amounts Paid</i>	177
<i>Contract Component Premiums Paid Issues</i>	179
<i>Transaction Processing</i>	181

REFERENCES.....	181
REDUCTION TESTING.....	182
DESCRIPTION.....	182
INTENT	182
DETAILED SPECIFICATIONS	182
<i>What can cause a reduction?</i>	182
<i>When is testing performed?</i>	183
<i>Determining if a reduction in benefits has occurred.</i>	184
<i>Re-computation requirements if a reduction in benefits has occurred.</i>	186
<i>Deemed Cash Surrender Value</i>	187
<i>Re-testing</i>	187
<i>Necessary Premium Testing / Updating</i>	189
<i>MEC classification</i>	189
<i>Examples</i>	190
INFORMATION REQUIREMENTS.....	191
REFERENCES.....	191
MATERIAL CHANGES	192
DESCRIPTION.....	192
INTENT	192
DETAILED SPECIFICATIONS	192
<i>Material Change Detection</i>	192
<i>Deemed Material Changes</i>	192
<i>Material Changes for Traditional Life</i>	194
<i>Tested Material Changes</i>	197
<i>Not Material Changes</i>	197
<i>Material Changes and MEC Classification</i>	197
<i>Timing of Tests</i>	197
<i>Treatment of Grandfathered Contracts</i>	198
REFERENCES.....	198
NECESSARY PREMIUM TESTING	199
DESCRIPTION.....	199
INTENT	199
DETAILED SPECIFICATIONS	200
<i>When does a Material Change Occur?</i>	200
<i>What happens after a Necessary Premium Testing induced Material Change?</i>	200
<i>Benefit Increase</i>	200
<i>When is testing performed?</i>	201
<i>Material Change Change Impact</i>	201
<i>Unnecessary Premium</i>	202
<i>Unnecessary Premium For a Cash Value Accumulation Tested Product</i>	203
<i>Net Premium</i>	203
<i>Net Premium for Traditional Life</i>	204
<i>Maximum Necessary Premium</i>	208
<i>Net Single Premium</i>	208
<i>Net Single Premium – Traditional Life</i>	208
<i>Net Single Premium for a Test Year</i>	209
<i>Net Single Premium for the Lowest Death Benefit for a Test Year</i>	209
<i>Net Single Premium for the Present Value of the Future QAB Charges for a Test Year</i>	209
<i>Net Single Premium for the Present Value of the Future QAB Premiums for a Test Year</i>	209
<i>Net Single Premium Factor</i>	210
<i>Deemed Cash Surrender Value – Variable Products</i>	210
<i>Shadow Contracts</i>	211
<i>Shadow contracts</i>	212

Deemed Cash Value / Shadow Contract Updating	213
Deposits.....	213
Premium Deposit Charges	213
Withdrawals.....	213
Applicable Mortality and Expense Charges	219
Monthly Mortality and Expense Charges.....	219
Net Deemed Cash Value Annual Interest Rate.....	220
Guaranteed Cost of Insurance Charges.....	220
Deemed Cash Value Net Amount at Risk.....	220
Timing of Transactions for Deemed Cash Value.....	220
Deemed Cash Surrender Value Example.....	221
<i>Deemed Cash Surrender Value – Traditional Life</i>	222
Deemed Cash Value / Shadow Contract Updating – Traditional Life	222
<i>Net Necessary Premium</i>	226
<i>Net Unnecessary Premium</i>	226
<i>Gross Unnecessary Premium</i>	226
<i>Example</i>	227
<i>Impact of Reductions and Other Adjustments</i>	228
Reductions / adjustments for non-linear charges	232
<i>Deemed Cash Value Adjustments when the Lowest Death Benefit or a QAB is Reduced on Traditional Contracts</i>	239
<i>Deemed Cash Value Adjustments when a QAB is Reduced on Traditional Contracts</i>	239
<i>Material changes on Traditional Life Contracts</i>	241
Deemed Cash Value Adjustments upon a Material Change	241
Calculation of Attained Age when a Material Change Occurs	242
Material Change due to the Payment of an Unnecessary Premium	242
<i>Information Requirements</i>	249
<i>Traditional Life Example</i>	251
GRANDFATHER TESTING - TAMRA	253
DESCRIPTION	253
INTENT	253
DETAILED SPECIFICATIONS	253
<i>Date Entered Into</i>	253
<i>Loss of TAMRA Grandfathering</i>	254
<i>\$150,000 Rule</i>	254
<i>Applicable Death Benefit</i>	255
<i>Grandfather Testing</i>	255
REFERENCES.....	255
1035 EXCHANGES - INCOMING	256
DESCRIPTION	256
INTENT	256
DETAILED SPECIFICATIONS	257
<i>Incoming 1035 At Issue</i>	257
<i>Subsequent transactions</i>	257
<i>1035 payment window acceptance test</i>	257
<i>1035 Premium Payment</i>	257
<i>1035 Cost Basis Carryover</i>	258
<i>1035 Cash Value Carryover</i>	258
<i>TAMRA</i>	258
<i>MEC Status Carryover</i>	258
<i>Mirrored Loan</i>	259
<i>Cost basis / MEC Status updating after the payment has been processed</i>	259
<i>Information required</i>	260
1035 EXCHANGES - OUTGOING	262

DESCRIPTION	262
INTENT	262
DETAILED SPECIFICATIONS	262
<i>Tax System Processing of the Old Policy</i>	262
<i>Exchange of a Policy with an Outstanding Loan</i>	262
<i>Cash Value Carryover</i>	263
<i>Previous Distributions</i>	263
TRANSACTION CONSIDERATIONS	264
DESCRIPTION	264
DETAILED SPECIFICATIONS	264
<i>Tax Events</i>	264
<i>Non-Tax Events</i>	265
<i>Special transactions</i>	265
<i>Transaction Timing</i>	266
<i>Premium Payments</i>	266
<i>Advanced discount payments</i>	266
<i>Other payments</i>	267
Payments for Paid up insurance.....	267
Premiums paid by dividends.....	267
<i>Examples</i>	267
<i>Payment reversal</i>	268
<i>Transaction Granularity</i>	268
SETTLEMENT OPTIONS.....	271
DESCRIPTION	271
SETTLEMENT OPTIONS	271
SETTLEMENT DIVIDENDS.....	271
EVENT AMOUNT	272
APPENDICES.....	273
GLOSSARY	281
ERRORS & ALERTS	282
KCI TAX SERVER ALERTS.....	282
REFERENCES	284