LexisNexis Tax Advisor -- Federal Topical § 1A:5.02

LexisNexis Tax Advisor -- Federal Topical

Part 1. Computing Federal Income Tax

Vol. 1A Gross Income & Exclusions

CHAPTER 1A:5 Taxation of Life Insurance and Death Benefits **

LexisNexis Tax Advisor -- Federal Topical § 1A:5.02

§ 1A:5.02 Definition of Life Insurance Contract

In order for the proceeds of a contract to be eligible for the

exclusion from gross income, it must meet three separate definitional requirements for a life insurance contract. First, it must qualify as life insurance under applicable law. Second, it must qualify as life insurance under judicial and administrative rules. Third, it must meet the definition of a life insurance contract of IRC Section 7702, a complex multi-faceted test to determine if the contract is designed primarily to provide a death benefit, and is not primarily an investment vehicle.

[1] In General

Non-tax statutory requirement: Before any of the tax-favored attributes of a life insurance contract may be available, the contract has to meet applicable state or foreign law requirements for qualification as a life insurance contract.

Judicial and administrative requirements: Case law and rulings have raised the issue of whether a contract will be eligible for the exclusion from gross income under two circumstances. The first is when the contract does not provide life insurance protection, that is, shifting and spreading the risk of death.[1] Application of this principal can be found in a Revenue Ruling, where the value of the contract was not larger at the death of the insured than it was during the lifetime of the insured, so there was no exclusion from gross income that would otherwise be available for life insurance contract death benefits.[2]

Example:

The insured simultaneously purchases an annuity and a life insurance contract from the same carrier. Immediately before the death of the insured, the annuity is worth $500,000 and the life insurance contract is worth $0. Immediately after the death of the insured, the annuity is worth $0 and the life insurance contract is worth $500,000. Taken together, the insurance company has not taken any economic risk that would be triggered upon the death of the insured. Accordingly, the contract does not qualify as insurance.

The other circumstance is when the beneficiary does not have an insurable interest. For example, the Court of Appeals for the Fifth Circuit looked at an arrangement where a company (the taxpayer) maintained accident insurance for its employee truckers, but required that the employees designate the company as beneficiaries of a life insurance component of the contract. The Fifth Circuit affirmed a District Court ruling that the employer had no insurable interest in the life insurance contract. Accordingly, the Court treated the contract as a wagering contract rather than an insurance contract, and denied the IRC Section 101 exclusion from gross income.[3]

Tax-law requirement:IRC Section 7702 creates a special definition for "life insurance contract." In addition to the fact that it must qualify as a life insurance contract under applicable law, it must also meet one of two tests.[4] These are the cash value accumulation test, and the guideline premium and cash corridor test.

The underlying principle of IRC Section 7702 is to make sure that the cash value of a contract is not disproportionately large when compared with the death benefit, since the primary function of life insurance is to provide a death benefit rather than a tax-favored investment.

[2] Cash Value Accumulation Test

The basic requirement here is fairly straightforward. By the terms of the contract, the cash surrender value of the contract "may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract."[5] In making this calculation, certain rules apply:

- •
  The interest rate assumed is the greater of four percent or the amount guaranteed by the contract.
- •
  Mortality charges must be reasonable, and must use prevailing standard actuarial tables as of the time the contract is issued.
- •
  Other charges must be reasonable, and must be reasonably expected to be paid, based on the company's experience with similar contracts, if any.[6]

If the cash value accumulation test is not met, the contract may alternatively qualify as a life insurance contract if the guideline premium requirements and cash value corridor test are met.

[3] Guideline Premium Requirements and Cash Value Corridor Test

In order to meet this alternative to the cash value accumulation test, both of these requirements must be satisfied:

*Guideline Premium Requirements:*IRC Section 7702 provides that the sum of the premiums paid under the contract cannot at any time exceed the "guideline premium limitation" at such time.[7] This is defined by IRC Section 7702 as the greater of the following two amounts:

(A) the amount that would be required to fully fund future benefits under the contract, if paid as a single premium on the date the contract is issued, or

(B) the amount that would be required to fully fund future benefits under the contract, if paid as level annual premiums through age 95.[8]

The actuarial rules described in Section 1A:5.02[2], above, will apply in making these calculations, except that in calculating the single premium, an interest rate of six percent is used, and in calculating the level annual premiums an interest rate of four percent is used.

Cash Value Corridor Test: Under this test, the death benefit under the policy must be a minimum percentage of the cash surrender value. The percentage is based on the age of the insured.[9]

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentage shall decrease by a ratable portion for each full year:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

[4] Contracts Issued Before 1985

IRC Section 7702 was enacted in 1984.[10] As a general rule, contracts issued before 1985 are not subject to this section. However, under a transitional rule, IRC Section 7702 may apply to contracts issued before June 30, 1984 that have an increasing death benefit, and are funded more quickly than by 10 annual level premiums.

Contracts issued before 1985 are governed by an earlier provision upon which IRC Section 7702 was based,[11] which focuses on the relationship between the insurance component of the contract and the investment component, and denies favorable tax treatment if the contract resembles an investment more than an insurance product. Unlike IRC Section 7702, which denies favorable tax treatment to cash value increases but not death benefits, the earlier provision denied all benefit of the IRC Section 101 exclusion if the contract too closely resembled an investment rather than an insurance product.

The earlier provision, IRC Section 101(f), addressed the "flexible premium life insurance contract." This is defined as a life insurance contract which provides for the payment of one or more premiums that are not fixed by the insurer as to both timing and amount.[12]

A flexible premium life insurance contract issued before 1985 will be eligible for the income tax exclusion under IRC Section 101 only if certain tests are met. These mirror the IRC Section 7702 tests, with some modifications. For instance, instead of the current percentages in the cash value corridor test, the applicable percentage is 140 percent for an individual aged 40 or less, minus one percentage point for each year the insured is over age 40, but not reduced to less than 105 percent.[13] Flexible premium life insurance contracts are discussed further in § 1A:5.08, below.

[5] Revenue Procedures for Correcting Life Insurance Contract Failures

The IRS released five revenue procedures in the summer of 2008 that provide relief when an insurance company's life insurance contract fails to meet the definitional requirements under IRC Section 101 or IRC Section 7702. Two of the revenue procedures are particularly helpful and relevant.[14]

Revenue Procedure 2008–42 provides an automatic waiver for issuers who fail to meet the definitional requirement for life insurance contracts in the event of certain “eligible reasonable errors.”[15] The IRS waives the failure for the individual contract holders with respect to taxability of insurance proceeds in such cases as well.[16]

If the automatic waiver is not available to an issuing insurance company, the company may still be eligible for a correction by closing agreement as provided in Revenue Procedure 2008–40. Under this procedure, the IRS can agree in the closing agreement to treat contracts, and amounts already paid, as qualifying under the life insurance contract definition so that it is not included in an individual’s income.[17]

FOOTNOTES

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(1) E.g., Helvering v Le Gierse, 312 U.S 156 (1941); Fidelity-Philadelphia Trust Co v Smith, 356 US 274 (1958); Rev Rul 2005-40, 2005-27 IRB 4.

(2) Rev Rul 55-313, 1955-1 CB 219.

(3) Atlantic Oil Co. v. Patterson, 331 F2d 516 (5th Cir 1964).

(4) IRC § 7702(a).

(5) IRC § 7702(b)(1).

(6) IRC § 7702(b)(2).

(7) IRC § 7702(c)(1).

(8) IRC § 7702(c)(2).

(9) IRC § 7702(d).

(10) Pub L No 98-369, 98th Cong, 1st Sess § 221(a) (1984)

(11) IRC § 101(f).

(12) IRC § 101(f)(3).

(13) IRC § 101(f)(3).

(14) See Rev Proc 2008-38, 2008 IRB LEXIS 498; Rev Proc 2008-39, 2008 IRB LEXIS 501; Rev Proc 2008-40, 2008 IRB LEXIS 500; Rev Proc 2008-41, 2008 IRB LEXIS 499; Rev Proc 2008-42, 2008 IRB LEXIS 497 (all effective July 21, 2008).

(15) Authority for this kind of waiver is provided in IRC § 7702(f)(8) and IRC § 101(f)(3)(H).

(16) See Rev Proc 2008–42, 2008 IRB LEXIS 497.

(17) See Rev Proc 2008–40, 2008 IRB LEXIS 500 (Model Closing Agreement).