

Part 1

Section 7702.—Life Insurance Contract Defined (Also § 7702A.)

Rev. Rul. 2005-6

ISSUE

For purposes of determining whether a contract qualifies as a life insurance contract under § 7702 of the Internal Revenue Code and as a modified endowment contract under § 7702A, should charges for qualified additional benefits (QABs) be taken into account under the mortality charge rule of § 7702(c)(3)(B)(i) or the expense charge rule of § 7702(c)(3)(B)(ii)?

FACTS

IC is a life insurance company organized and licensed to do business in State. In Year, IC issued a Policy in State with a Rider that provides term life insurance coverage on the life of a family member of the individual insured by the Policy. The Policy is a life insurance contract under the law of State and was designed to qualify as a life insurance contract under § 7702 by meeting the guideline premium requirements of § 7702(c) and falling within the cash value corridor of § 7702(d). IC imposes a charge

for the mortality risk that it assumed pursuant to the Rider and subtracts this charge monthly from the Policy's cash value.

LAW AND ANALYSIS

Section 7702(a) provides that, for a contract to qualify as a life insurance contract for Federal income tax purposes, the contract must be a life insurance contract under the applicable law and must either (1) satisfy the cash value accumulation test of § 7702(b), or (2) both meet the guideline premium requirements of § 7702(c) and fall within the cash value corridor of § 7702(d).

A contract meets the guideline premium requirements of § 7702(c) if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation as of that time. The guideline premium limitation as of any date is the greater of (A) the guideline single premium, or (B) the sum of the guideline level premiums to that date. The guideline single premium is the premium that would be required on the date the contract is issued to fund the future benefits under the contract, based on the following three elements enumerated in section 7702(c)(3)(B):

(i) reasonable mortality charges that meet the requirements (if any) prescribed in regulations and that (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued;

(ii) any reasonable charges (other than mortality charges) that (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid; and

(iii) interest at the greater of an annual effective rate of six percent or the rate or rates guaranteed on issuance of the contract.

The guideline level premium is the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis but using a minimum interest rate of four percent, rather than six percent.

A contract meets the cash value accumulation test of § 7702(b) if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. This determination is made, in part, on the basis of the mortality charge rule of § 7702(c)(3)(B)(i) and, in the case of QABs, the expense charge rule of § 7702(c)(3)(B)(ii).

Section 7702(f)(4) defines the term “future benefits” to mean death benefits and endowment benefits. Section 7702(f)(5)(A)(iii) characterizes family term riders as QABs. Section 7702(f)(5)(B) provides that QABs are not treated as future benefits under the contract, but the charges for such benefits are treated as future benefits. Accordingly, charges for the Rider should be accounted for as future benefits under the Policy.

Under the mortality charge rule of § 7702(c)(3)(b)(i), reasonable mortality charges are taken into account if they meet the requirements (if any) prescribed in regulations and do not exceed the mortality charges specified in the prevailing commissioners' standard tables as of the time the contract is issued. There is no requirement that the charges taken into account be charges that are expected to be

paid. In contrast, under the expense charge rule of § 7702(c)(3)(B)(ii), reasonable charges other than mortality charges are taken into account only if they are reasonably expected to be actually paid. For this reason, accounting for charges for the Rider under the mortality charge rule, rather than the expense charge rule, would in some cases produce a higher net single premium and higher guideline level premiums for purposes of testing a contract's compliance with § 7702.

Section 7702A defines a modified endowment contract (MEC) generally as a contract that meets the requirement of § 7702 but fails to meet the 7-pay test set forth in § 7702A(b) (or that is received in exchange for a contract that is otherwise a MEC). Under § 7702A(b), a contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before that time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. For this purpose, § 7702A(c)(1) provides that determinations under the 7-pay test are made by applying the cash value accumulation test rules of § 7702(b)(2). Under that provision, charges for QABs are accounted for under the expense charge rule of § 7702(c)(3)(B)(ii).

Section 7702 is silent on the treatment of charges for QABs for purposes of determining whether a contract satisfies the guideline premium requirements. Under § 7702(b)(2)(B), however, charges for QABs are subject to the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of determining whether a contract satisfies the cash value accumulation test. The same rule applies under § 7702A(c)(1) for purposes of

determining whether a contract satisfies the 7-pay test and therefore is not a MEC. There is no indication that Congress intended charges for QABs to be accounted for under one rule for purposes of the cash value accumulation test of § 7702(b) and the 7-pay test of § 7702A(b), and under a different rule for purposes of the guideline premium requirements of § 7702(c). Moreover, there is no indication that Congress intended to take into account charges with respect to QABs that exceed amounts reasonably expected to be actually paid. Accordingly, charges taken into account with respect to QABs are subject to the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of the guideline premium requirements.

HOLDING

Charges for QABs should be taken into account under the expense charge rule of § 7702(c)(3)(B)(ii) for purposes of determining whether a contract qualifies as a life insurance contract under § 7702 or as a MEC under § 7702A.

EFFECTIVE DATE

This revenue ruling is effective February 7, 2005.

APPLICATION

The following alternatives are available to issuers whose compliance systems do not currently account for charges for QABs under the expense charge rule of § 7702(c)(3)(B)(ii):

A. If an issuer's compliance system does not properly account for charges for QABs but no contracts have failed to satisfy the requirements of § 7702(a) as a result of

the system's deficiency, the issuer may correct its compliance system to account for those charges using the expense charge rule without contacting the Service.

B. If an issuer's compliance system does not properly account for charges for QABs and, as a result, some life insurance contracts do not meet the definition of life insurance contract under §7702(a), the issuer may request a closing agreement on or before February 7, 2006 under the procedures set forth in Rev. Proc. 2005-1, 2005-1 I.R.B. 1. In addition to the modifications to the ruling process provided by Rev. Proc. 2001-42, 2001-2 C.B. 212 (concerning inadvertent MECs), and Rev. Rul. 91-17, 1991-1 C.B. 190, as supplemented by Notice 99-48, 1999-2 C.B. 429 (concerning failures under §7702(a)), the following modifications will apply to a closing agreement requested under this revenue ruling:

1. the issuer must identify all contracts administered under the compliance system, but need not identify which contracts fail to meet the requirements of §7702(a) or are inadvertent MECs under §7702A;
2. the contracts identified in the closing agreement will not be treated as failing the requirements of §7702(a) or as MECs under §7702A by reason of improperly accounting for charges for existing QABs, including future charges resulting from an increase in an existing QAB or the addition of a new QAB pursuant to the exercise of a right that existed in the contract before April 8, 2005, relief under the closing agreement will not extend to improper accounting for charges for an increase in an existing QAB or the addition of a new QAB that are not pursuant to the exercise of a right that existed in the contract before that date;

3. no corrective action need be taken with respect to the compliance system or with respect to contracts identified in the closing agreement;
4. in lieu of an amount based on the tax and interest that would have been owed by the policyholders if they were treated as receiving the income on the contract, the amount due under the closing agreement will be based on the aggregate number of contracts for which relief is requested, as set forth in the following schedule:

Number of Contracts	Amount due
20 or fewer	\$1,500.00
21 to 50	\$2,000.00
51 to 100	\$5,000.00
101 to 500	\$10,000.00
501 to 1,000	\$16,000.00
1,001 to 5,000	\$30,000.00
5,001 to 10,000	\$40,000.00
Over 10,000	\$50,000.00

5. the request for a closing agreement must be submitted to the appropriate address and with the appropriate user fee set forth in Rev. Proc. 2005-1; in addition, the closing agreement should reflect the following address for mailing the closing agreement and amount due, after the closing agreement has been executed by the Service: Internal Revenue Service, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

C. After February 7, 2006, an issuer whose compliance system does not properly account for charges for QABs may request a closing agreement under the terms and conditions set forth above, except that (1) the closing agreement must identify the contracts that fail to meet the requirements of § 7702(a) or are inadvertent MECs under § 7702A; and (2) the closing agreement must require the issuer to correct its compliance system and to bring the identified contracts into compliance with § 7702(a) or § 7702A, as appropriate.

DRAFTING INFORMATION

The principal author of this revenue ruling is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Melissa S. Luxner at (202) 622-3970 (not a toll-free call).