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Federal Income Taxation of Life Insurance Products After the Tax Reform Act of 1984

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FEDERAL INCOME TAXATION OF LIFE INSURANCE PRODUCTS AFTER THE TAX REFORM ACT OF 1984

INTRODUCTION

The Tax Reform Act of 1984[1] (the 1984 Act) made sweeping changes[2] to the law affecting the taxation of life insurance companies and life insurance products.[3] The 1984 Act repealed the sections dealing with life insurance companies in Subchapter L of the Internal Revenue Code[4] and replaced them with entirely new Code sections.[5] The Act also adds a Code section defining a life insurance contract. This new definition controls the tax status of life insurance products.[6] If a life insurance contract fails to qualify under the definition, then the policyholder and the beneficiary are subject to federal income taxation on certain cash value accumulations and on death benefits paid.[7]

The effect of the new law is to restrict the favorable tax status once enjoyed by the life insurance industry. The life insurance industry enjoyed this favored tax status in two important respects: insurance companies escaped federal taxation of income from premiums and interest on investments,[8] and life insurance products

1. The Act is Division A of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified in scattered sections of 26 U.S.C.).

2. The changes were made by revising Subchapter L of the Internal Revenue Code (I.R.C. §§ 801 — 845).

3. A life insurance product may be defined as "[a] contract between the holder of a policy and an insurance company (i.e., the carrier) whereby the company agrees, in return for premium payments, to pay a specified sum (i.e., the face value or maturity value of the policy) to the designated beneficiary upon the death of the insured." BLACKS LAW DICTIONARY 723 (5th ed. 1979).

4. All Code sections refer to the Internal Revenue Code of 1954 as amended unless otherwise indicated.

5. Pub. L. No. 98-369, § 211, 98 Stat. 494, 719-777 (amending I.R.C. §§ 801 — 884). *See also* Harman, *The Structure of Life Insurance Company Taxation — The New Pattern Under the 1984 Act* (pts. 1 & 2), 39 J. AM. Soc. CLU 56, 76 (1985).

6. Pub. L. No. 98-369, § 221, 98 Stat. 494, 767 (codified at 26 U.S.C.] 770]2).

7. Pub. L. No. 98-369, § 221, 98 Stat. 494, 770 (codified at 26 U.S.C. § 7702).

8. I.R.C. § 809(a) (1982) (excluding certain investment yield set aside for policyholders); I.R.C. § 809(d) (1982) (allowing deductions for death benefit reserves, policyholder dividends, and death benefit claims and losses accrued).

escaped income taxation.[9] Life insurance policy beneficiaries are not taxed on proceeds paid upon the death of the insured nor is the insured taxed on the dividends he receives or on the increases to cash value of the policy.[10]

These exemptions from federal income taxation run counter to the all-inclusive income principle which is well established. That principle holds that the statutory phrase "gains or profits and income derived from any source whatever" is extended to include all gains except those which are specifically exempted.[11]

By escaping taxation at both the provider and recipient levels, the life insurance policyholder benefits from a potential return greater than that on other investment vehicles. He realizes this benefit at the expense to the government of lost revenue. Even if the policyholder is taxed on certain accumulations, he may defer taxation of income on those accumulations.[12] Therefore, he benefits from the time value of money[13] on the potential tax liability until the tax is paid.

The 1984 Act has overhauled the complex law of taxation of life insurance companies and life insurance products. The changes were necessary due to the evolution of both companies and products in a financial world where competition has all but destroyed the traditional lines of demarcation between insurance companies, investment companies, and financial institutions.[14] Today's life insurance product is as much an investment vehicle as it is risk cov-

9. I.R.C. § 72(e) (1982) (regarding dividends paid to the policyholder); I.R.C. § 101(a) (1982) (regarding proceeds of life insurance contracts payable by reason of death).

10. I.R.C. § 101(a) (1982) excludes the proceeds from life insurance contracts payable by reason of death. I.R.C. § 72(e) (1982) treats policyholder dividends as income only in excess of premiums paid. Therefore, loans and dividends will not normally exceed the premiums paid so that no income results from these distributions. Constructive receipt of income is not provided for in I.R.C. § 72 (1982).

11. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955).

12. Under I.R.C. § 72(b) (1982), if the life insurance contract provides for a return in the nature of an annuity, then the income received is taxed according to an exclusion ratio which, in effect, spreads the income earned under the contract over the life of the contract.

13. The time value of money is also known as its present value. Present value is defined as "[t]he value now of a sum of money arising in the future. Money now is worth more than money in the future, because it could be invested now to produce a greater sum in the future." D. AULD, G. BANNOCK, R. BAXTER & R. REES, THE AMERICAN DICTIONARY OF ECONOMICS 247 (rev. 2d ed. 1983).

14. For example, E.F. Hutton has a life insurance company division, and much of the product it offers is based on high yield securities. The product thus provides both life insurance protection and near market investment yields.

erage for the insured.[15]

The 1984 Act provides a statutory definition of life insurance for the first time.[16] The definition is the vital link to the exemption from federal income taxation.[17] Therefore, setting the parameters of what products enjoy the favored tax status will have a broad effect on the entire industry, as well as on related investment opportunities.[18]

I. Life Insurance Products

The traditional theory of life insurance is that it shifts the risk of premature death from the insured to the insurance company, which in turn distributes this risk over a large number of policyholders. Life insurance protection exists in formats along a continuum from term insurance to whole life coverage.[19] It also exists in combination with annuities which may pay specified amounts to the insured, typically during retirement, if the insured does not die prematurely.

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15. The traditional purpose of life insurance has been to provide a shifting of the risk of premature death from the insured to the insurance company, which in turn distributed the risk over a large number of policyholders. In principle, the premium which the policyholder pays creates a fund which accumulates interest over the life of the policy at low rates of interest. Death benefits are then paid from this fund. Whole life policies, as opposed to term insurance policies, accrue a cash value over time, and therefore provide a form of investment for the insured.

16. A limited statutory definition of life insurance existed under I.R.C. § 1035(b)(3) (1982) relating to certain exchanges of insurance policies. That provision defined a life insurance contract as "a contract . . . which is not ordinarily payable in full during the life of the insured." The definition related to the exchange of a life insurance contract for another life insurance contract or for an endowment or annuity. Pub. L. No. 98-369, § 224, 98 Stat. 494, 776 (1984) amends I.R.C. § 1035(b) relating to the definition of an endowment contract, but it leaves the life insurance contract definition intact for purposes of exchanges.

17. The exemptions in both I.R.C. §§ 72 and 101 (1982) apply to life insurance contracts.

18. In today's financial market the consumer faces many choices in investment vehicles. Each of these competes for his investment dollar. If the competitive advantage is removed for one product in the market, then other products will not face the competitive pressure and may comfortably reduce the yield they now provide.

19. Term insurance provides coverage for the shortest period of time, and it does so at the lowest initial cost. Whole life insurance provides permanent coverage at a substantially higher initial cost. Each provides death protection, and each has as its primary purpose the creation or building of a capital fund. An endowment provides for the payment of a survivorship benefit to the insured at a specified date if he lives until that date. An annuity is merely a series of endowments paid over successive periods. All life insurance products can be considered in light of the combination of these death benefits and survivorship benefits. *See* S. Huebner & K. Black, Jr., Life Insurance 66-67 (1982).

A term insurance premium covers the insured for a specific time period, commonly one year, and the premium is lowest for younger policyholders.[20] Term insurance expires at the end of the term, and the premium represents the pure insurance cost for the period. Since the risk of death increases with the age of the policyholder, the premium begins low for younger policyholders and increases dramatically for older policyholders as the probability of death approaches certainty.[21]

Whole life insurance covers the insured for his entire life, and theoretically the premium represents one payment.[22] Today, the premium is normally spread over a period of time, but the idea remains the same. The theory is that if an insured invests a certain amount, then that amount accumulates interest over time and will equal the face amount of the policy on the statistically projected date of his death.[23] When a whole life premium is paid over a period of time, part of each premium provides life insurance coverage for the difference between the total amount paid in and the total which would have been paid in under a single premium whole life policy.[24]

In a whole life policy, a portion of each premium accumulates interest over time as cash value while another portion covers the risk expense of the difference between the cash value and the face amount of the policy. This difference is called the net amount at risk and as the cash value increases each year, the net amount at

20. For example, the following premiums of a policy issued by Traveler's Insurance Company for a yearly renewable term policy, face amount of $100,000, are indicative of the range:

age 35	$244
age 40	$325
age 45	$487
age 50	$752
age 54	$1,102

This compares to a constant annual premium of $1,385 for a whole life policy, face amount $100,000, issued by Traveler's Insurance Company. These rates are provided for illustrative purposes only and were prepared by Computone Systems, Inc., Dunwoody Park, Atlanta, Georgia 30338, which is an independent computer service and is not affiliated with any insurer or financial institution.

21. *See id.* (an illustration of the progression in rates with the advance in age of the insured).

22. There are two types of whole life policy: ordinary life, which spreads the payment over the life of the policy; and limited payment life, which provides coverage for the life of the insured, but which requires premiums for a limited number of years (or even a single payment). *See* S. HUEBNER & K. BLACK, JR., *supra* note 19, at 77.

23. *Id.* at 79-80.

24. *Id.*

risk decreases.[25]

The policyholder is the owner of the policy, and he may borrow against the cash value in a life insurance policy without obligation to repay the loan until the death of the insured. On the death of the insured, any unpaid policy loans are deducted from the life insurance proceeds payable at the death of the insured. This benefit may appear at first to be only the present use of life insurance proceeds at below market interest rates. However, the policyholder receives one important benefit from borrowing against the life insurance policies he owns. The interest he pays on those policy loans is tax deductible.[26] If the policyholder is able to manipulate the payments to his policy, he may be able to accumulate a large cash value, which reduces his net amount at risk. With a low net amount at risk, the policyholder has a low amount for the mortality charge portion of the premium. At the same time, the cash value is accumulating interest free of income tax. This cash value will be passed tax free on the death of the insured. By making a policy loan on the cash value, the policyholder has the use of the accumulated tax-free income at a subsidized interest rate. Therefore, the policyholder has access to his income, he may defer taxation on income, and he may receive a tax deduction for interest payments. This combination is not available in other forms of tax-free income.

The cash value in a life insurance policy, however, is an illusory amount. The cash value itself is available only upon termination of the policy. The policyholder must forfeit the policy in order to actually receive the amount called cash value. Thus, the accumulation and the interest income credited to the cash value is neither realized nor recognized by the policyholder under a traditional life insurance policy. Consequently, it could be argued that under our system of taxation it would be grossly unfair to impose an income tax on an amount which the taxpayer may never realize. As discussed above, the policyholder may obtain a policy loan against this cash value. In this way an insured may obtain an amount equal to the cash value without forfeiting the policy. Therefore, while the policyholder may not have access to the actual cash

25. *Id.* at 7-9.

26. I.R.C. § 163(a) (1982) allows a deduction for all interest paid or accrued. Interest on policy loans is not excluded from this Code section. Therefore, policy loan interest is treated like all other interest expenses. *See* Harriss, *Proposals to Tax Life Insurance Savings as Personal Income: As Economic, Fiscal and Social Policy Such Expedients Appear Ill-Advised,* 43 AM. J. ECON. & SOC. 427 (1984).

value, he may approximate the amount through a policy loan.[27]

If the life insurance spectrum is defined by the whole life policy at one end and the term policy at the other, then a wide variety of other options exists between these two ends of the spectrum. For example, the period of payments may be limited to a specific period for paid up whole life coverage. A twenty-year payment period is common. Also, the face amount may decrease over time. Most policyholders predict that the need for coverage decreases as the need for income decreases and the income earning period becomes shorter. This decrease in face amount reflects that prediction, and allows the premium to remain constant. While the risk is increasing, the face amount is decreasing. There may also be a combination of coverages, e.g., term, annuity and whole life. The coverages may be based on a combination of lives, e.g., the last survivor of a husband and wife. There are many other variations, but the principles of life insurance remain the same.

Life insurance products may be either participating or nonparticipating.[28] Participating policies pay dividends, and are usually issued by mutual companies.[29] Nonparticpating policies are issued by stock companies and do not pay dividends.[30] Mutual companies are, in effect, owned by the policyholders, although these policyholders do not exercise control over the company as would corporate stockholders.[31] Stock companies are owned by stockholders and usually do not pay policy dividends. However, stock companies are not prohibited from issuing participating policies. They may issue such policies, and they have done so when competitive pressures have given rise to the need to do so.[32]

The dividends which the policyholder receives are not true dividends in the corporate sense. The dividend represents a predetermined amount which the policyholder pays in advance as premiums, even though most believe the policy dividend entails a return on investment. This dividend is enhanced by savings in the mortality charge (cost of risk coverage), by savings in loading (cost of sales and administration), and by increased earnings on invest-

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27. The policyholder continues to have interest credited to the cash value during the time he has a policy loan outstanding. The interest he pays on the policy loan is often similar to the rate which is guaranteed on the cash value accumulation.

28. S. HUEBNER & K. BLACK, JR., *supra* note 19, at 398.

29. *Id.*

30. *Id.*

31. *See id.* at 402.

32. *See id.* at 567-68.

ments.[33] Most of the earnings on investments are already factored into the premium cost. Thus, only the difference in earnings due to market fluctuations is accounted for in this portion of the life insurance policy dividend.[34]

II. Tax Treatment of Life Insurance Products

For federal income tax purposes the dividends paid under a participating policy are treated as a return of premium and are not taxed to the recipient.[35] Also, the cash value which accumulates interest is not included as taxable income to the insured.[36] The Internal Revenue Service treats the contract as one for life insurance protection only. Therefore, the savings element is not deemed to exist separately.[37] However, there is authority for holding that one document may embody two contracts so that the savings element may subject the policyholder to tax liability for accumulations due to interest income credited to the fund.[38]

Likewise, the proceeds of life insurance which are paid on the death of the insured are not taxed as income to the beneficiary.[39] There are restrictions as to ownership of the policy,[40] and there are certain adverse effects which may occur if the policy is transferred for value.[41]

III. The Evolution of Life Insurance Products

In the past, life insurance policies emphasized protection, not investment, and the amount of interest accumulated annually on

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33. *Id.* at 399.
34. *See id.* at 400.
35. *See* I.R.C. § 72(e)(4)(B) (1982).
36. There is no provision for the constructive receipt of income under I.R.C. § 72 (1982).
37. Moseley v. Commissioner, 72 T.C. 183, 188-89 (1979).
38. *Id.* This case was analyzed by Internal Revenue Service Interpretive Division Director George H. Jelly in General Counsel Memorandum 38934, July 9, 1982, to be authority for the fact that a document may embody two contracts, even though the tax court held that distributions from a special reserve fund constituted a nontaxable return of premiums since these distributions were less than the total premiums paid under the policy. 17 Tax Notes 1001, 1007 (1982).
39. I.R.C. § 101 (1982).
40. I.R.C. § 101(b) (1982) (covering employees' death benefits).
41. Under I.R.C. § 101(a)(2) (1982) the amount excluded from income taxation may not exceed the actual value paid by the transferee plus any additional premiums paid. Also, under I.R.C. § 72(g) (1982) the basis of a contract which is transferred for value is the actual value of the consideration paid plus the premiums and other consideration paid by the transferee after the date of transfer.

cash values was meager.[42] Today, however, many companies have attempted to take advantage of this favorable tax position and have issued many hybrid forms of life insurance. These new forms have been developed to be effective investment vehicles as well as risk sharing products.

Other life insurance companies have encouraged the sale of term insurance by demonstrating the advantages of buying low cost term coverage and investing the difference in premium cost over whole life coverage in current high yield investments.[43] Traditional whole life participating policies were based on low interest rates. When market interest rates rose sharply, the savings element in traditional whole life policies became particularly vulnerable to attack from other financial vehicles. The difference in income when compared to these other financial vehicles could no longer be ignored by the consumer.

The largest and oldest insurance companies are mutual companies. In mutual companies, the earnings which accumulate on the policy cash values are based on the entire portfolio of investments held by the company. Mutual company dividend distributions are also based on the entire portfolio. Generally, the bulk of the investments in the portfolio was made many years ago when interest rates were low. Although market interest rates have increased over the years, the mutual companies have been slow to convert the portfolios to current high yield rates.

Stock companies, on the other hand, are not bound to pay dividends based on the entire portfolio.[44] They may segregate a fund for a specific policy form.[45] Therefore, stock companies may create new policy forms which credit the policyholder with current high

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42. For example, as recently as July, 1980, a statistical study indicated many policies carried accumulation rates as low as five percent. BEST'S REVIEW, Nov. 1980, at 47.

43. The Atlanta-based agency A.L. Williams & Associates, one such company, claimed to have 25,000 agents operating in 43 states in 1980. This was prior to the full scale introduction of many investment-based life insurance products. Many policyholders cashed in whole life policies in favor of term policies. BEST'S REVIEW, Nov. 1980, at 10.

44. This fact allows the stock company to issue more investment-oriented types of life insurance such as universal life, without the need to form new companies.

45. A policy form is the contract which defines the rights and obligations of the policyholder and the insurer. The policy form must be approved by every state where the policy will be sold. The method of changing and updating insurance products is for the insurance companies to issue new policy forms as necessary. These new policy forms may carry higher guaranteed rates of return and more liberal benefits without affecting the rights and obligations of existing policyholders.

yield on the underlying investments for that policy form alone.[46] In this way, the stock company is able to adjust quickly. In times of falling interest rates, however, the mutual company would have the advantage since the entire portfolio would be at long term rates and would not be affected by short term fluctuations in the market.

IV. The New Life Insurance Products & Tax Benefits

Many stock companies have led the way in offering new products such as variable life, adjustable life, and universal life insurance products.[47] The evolution in insurance products has been accelerating since the companies first began experimenting during the early 1950's with products which were combined with investment vehicles.[48]

The introduction of universal life was seen by many as a means of stemming the tide of defection to "term only" insurance and continuing one of the traditional purposes of life insurance, which is to encourage savings and provide capital for long term borrowing.[49] The government has an interest in protecting the industry due to the savings function it performs.[50] With the universal life

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46. For example, the leading writers of universal life insurance post guaranteed rates which range between 9.5% and 12.5%, and the majority of these writers are stock companies. The 10 leading issuers for 1982 were all stock companies except one and were as follows:

1. Lincoln National
2. E. F. Hutton
3. Penn Mutual
4. Transamerica Assurance
5. American General
6. Integon
7. Capitol Holding
8. Western-Southern
9. Acacia National
10. Life of Virginia

Universal Life Insurance 1982, BEST'S REVIEW, June 1983, at 12.

47. For example, there are at least 225 companies now offering some form of universal life product which would be affected by adverse tax rulings. 22 TAX NOTES 63 (1984).

48. *See* Turner, *Innovation and Life Insurance Products: The Pace Quickens*, BEST'S REVIEW, March 1981, at 12. According to Mr. Turner, the advantages of universal life are as follows: (1) flexible premiums, (2) adjustable coverage, (3) current interest rate, (4) allowance of partial withdrawals, (5) disclosure of expenses, and (6) annual reports. None of these advantages exists in the traditional whole life policy.

49. *See id.*

50. For example, the total admitted assets of United States life insurance companies for 1983 were distributed as follows:

product, the policyholder contributes large amounts to the savings element and receives the benefit of having protection, which he is able to adjust to changing needs over his lifetime.[51] The policyholder pays a flexible premium amount each year, and may change both the type of policy (term insurance, whole life, or some variation) as well as the face amount of the policy.[52]

These features allow the policyholder to tailor his insurance to his changing needs, and yet remain insurable. He may decrease his coverage without cancelling a policy, and he may purchase additional coverage without qualifying or without being subject to new policy forfeiture periods for suicide, mistake in application, or preexisting illness.[53]

In a universal life policy, the policyholder pays premiums which are credited directly to an investment fund. This fund accumulates investment income at a near market rate. The charges for the mortality charge (pure insurance) and loading (sales and administration) are then made against this fund rather than being segregated as costs in the beginning.[54] In the universal life policy, loading is theoretically less expensive. With traditional life insurance policies the high sales expense of tailoring the coverage through the personal services of the salesperson is borne in the first year. In a universal life policy, the changes in policy features are handled ad-

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	(000,000 Omitted)		
ASSET		AMOUNT	PERCENT
Government Securities		66,386	10.1
Corporate Securities			
Bonds	193,958		29.5
Common Stock	29,966		4.1
Preferred Stock	12,835		2.0
Total Corporate		233,759	35.6
Mortgage		146,402	22.3
Real Estate		15,852	2.4
Policy Loans		55,734	8.2
Cash		3,259	0.5
Short-Term Investments		22,217	3.4
All Other		114,999	17.5
TOTAL ADMITTED ASSETS		656,608	100.0

BEST'S INSURANCE REPORTS, LIFE-HEALTH 1984 at ix.

51. *See generally* General Counsel Memorandum 38934, July 9, 1982, as published in 17 TAX NOTES 1001 (1982).

52. *Id.*

53. *See* 1984 BEST'S FLITCRAFT COMPEND at 12.

54. Since the costs of the life insurance are taken from the fund and not directly from a premium payment, the failure to pay a scheduled premium does not cause a lapse in coverage as it would in a traditional policy form. This feature allows the policyholder to miss a payment without penalty should the need arise.

ministratively on initiation by the policyholder rather than through a salesperson alone. Thus, the policyholder tailors his own life insurance coverage throughout the life of the policy without the services of the traditional life insurance salesperson.

As with a traditional whole life contract, the cash value in a universal life insurance policy may be borrowed against without obligation to repay until the death of the insured, at which time the loan is deducted from the proceeds payable at death. With the traditional whole life policy the policy loan interest was low (between four percent and six percent). Under universal life policies the interest rate is at or near the rate the insured is earning on the cash value accumulations. However, the interest he pays is tax deductible.[55] Therefore, as with traditional whole life insurance, the policyholder has access to his income, he may defer taxation, and he may receive a tax deduction for interest payments. This combination is not available in other forms of tax-free income.[56]

Universal life is but one variation of insurance on the market today which attempts to take advantage of the favorable tax treatment of life insurance. The attempts of the life insurance companies to allow the policyholder to control his investment have met with stiff resistance from the Internal Revenue Service. The Service, through regulations,[57] rulings,[58] private letter rulings,[59] court cases,[60] and code reform[61] has attempted to eliminate this poten-

55. I.R.C. § 163(a) (1982).

56. *See* H.R. Rep. No. 98-432, 98th Cong., 1st Sess. 258-259 (1983).

57. *See, e.g.*, Treas. Reg. § 1.72-11 (1984) (regulating the tax treatment of amounts not received as annuity payments); *see also* Treas. Reg. § 1.101-1 (1984) (regulating the exclusion from gross income of proceeds of life insurance contracts payable by reason of death).

58. *See, e.g.*, Rev. Proc. 83-45, 1983-1 C.B. 780. (The Commissioner ruled that no advanced ruling will be made as to whether a death benefit payable under a single premium increasing death benefit life insurance policy will be excludable from gross income of the beneficiary pursuant to I.R.C. § 101(a)).

59. *See* Priv. Let. Rul. 8236069. On June 11, 1982, the Service issued this private letter ruling to Massachusetts Mutual which had sought guidance on the tax consequences of issuing a universal life policy. Mutual companies were thought to be at a disadvantage when compared to stock companies in issuing universal life policies due to the difficulty in segregating investment funds for separate policies. Therefore, a rule adverse to universal life would in effect be favorable to the mutual companies. On June 14, 1982, Massachusetts Mutual issued a press release explaining the Service's holding. The Service held that the difference between the guaranteed maximum premium cost and the actual premium cost would result in a dividend to the policyholder. This dividend was deemed repaid to the insurance company as a premium.

60. *See, e.g.*, Moseley v. Commissioner, 72 T.C. 183 (1979).

61. *See* I.R.C. § 101(f) (1982) (Proceeds of Flexible Premium Contracts Payable by Reason of Death).

tially lucrative tax loophole. At the same time, the government has shown an interest in protecting the companies and the large number of existing policyholders.

V. Tax Treatment of Life Insurance Products Prior to 1984

The Internal Revenue Service has recently focused its concern on flexible premium life insurance products such as universal life. A life insurance contract which provides for one or more payments which are not fixed by the insurer both as to timing and amount is a flexible premium life insurance contract. The flexible premium adjustable life contract allows the policyholder to vary his payments each year as well as his coverage by both type of coverage and face amount. Thus it is possible for the policyholder to shelter large sums of accumulated income from taxation, and transfer the proceeds tax free on his death. He could obtain the benefit of using the cash accumulated in the policy by borrowing against the policy and deducting the interest charged against current income. The Service and Congress feared that the potential for abuse under such policies was great.

Some of the mutual companies saw the universal life product as a threat to their own traditional whole life products and sought adverse rulings both on the cash value accumulations and the death benefits payable. The Service issued a private letter ruling on June 14, 1982, which was adverse to universal life policies.[62] This private letter ruling reversed the position the Service had taken in 1979. The life insurance industry reacted quickly, and due to its intense efforts, Congress reversed the Service's position. It enacted a special provision in the 1982 tax legislation protecting flexible premium life insurance contracts within certain guidelines.[63]

This provision, enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[64] provided special rules for handling proceeds of flexible premium contracts payable by reason of death,[65] and applied to contracts entered into before January 1, 1984.[66] The new Code section provided mandatory guidelines to determine whether a death benefit paid under a flexible premium

62. *See supra* note 59.
63. I.R.C. § 101(f) (1982).
64. Pub. L. No. 97-248, 96 Stat. 324.
65. *Id.*
66. *Id.*

contract should be excluded from gross income.[67]

The policy must at all times meet one of two tests. First, the sum of the premiums paid must not exceed a specifically computed guideline premium. This restriction is aimed at preventing overpayment of premiums for the purpose of allowing excessive tax-free accumulation of investment income. Specific computational rules dictate the amount.[68] In addition, under this sum of the premiums test, the face value of the policy may not be less than a specified percentage of the cash value. For example, the applicable percentage at age forty is 140%, and the percentage decreases each year to a minimum of 105% at age seventy-six.[69] The alternative test is the cash value test, and provides that the cash value will not exceed the net single premium for the death benefit at any time.[70]

These rules applied only to flexible premium contracts, and were meant to be only a temporary measure. The Service later announced, however, that it would not seek adverse rulings on flexible premium policies even after the expiration of the special provisions. There have been many studies and much speculation as to the future treatment of flexible premium policies. In a General Counsel Memorandum, Internal Revenue Service Interpretive Division Director George H. Jelly concluded that a universal life product is, in substance, a combination of term insurance and a savings arrangement that may be severable for tax purposes.[71] Thus, the interest payments paid thereunder could be includable in the gross income of the policyholder. Further, the death benefits received under such a policy would be excluded from tax liability only to the extent of the term insurance provided.[72]

VI. THE TAX REFORM ACT OF 1984

Under the Tax Reform Act of 1984, rules similar to those established by TEFRA were extended to all life insurance contracts, and

67. I.R.C. § 101(f)(2)(A) (1982).

68. The general amount calculated in I.R.C. § 101(f)(1)(A) (1982) is modified by I.R.C. § 101(f)(2)(D) (1982). It is modified so that the excess amount calculated is not greater than at the time the contract was issued.

69. Under I.R.C. § 101(f)(3)(C) (1982) the applicable percentage applied against cash value begins at 140% at age 40. The percentage decreases by one percent each year after age 40, but does not decrease below 105% of cash value.

70. I.R.C. § 101(f)(1)(B) (1982).

71. General Counsel Memorandum 38934, July 9, 1982, as published in 17 TAX NOTES 1001 (1982).

72. *Id.*

not merely to flexible premium products.[73] Extensive studies were undertaken to explore solutions to the potential abuses thought to exist. The problem has two aspects. First, there are abuses at the company level and industry competition factors to consider. Second, there are abuses at the policyholder level in the form of a tax shelter.

The House Ways and Means Committee identified four areas of concern appropriate for legislation. First, the Committee found that insurance companies have begun to emphasize investment oriented products with larger cash value buildups and larger investments. Second, the Committee stated that withdrawals from annuities prior to retirement should not be penalty free. Third, the Committee considered the withdrawal of cash buildups within a policy via policyholder loans without taxation on the income buildup to be an abuse. Fourth, the limits on the term insurance provided to employees did not apply to retirees. The Committee stated that these limits should also apply to retirees.[73.1]

Aside from the general definition of a life insurance contract relating to tax-free exchanges, there is no statutory definition under present law. The Service and the courts have defined a life insurance contract over the years, and have considered such factors as risk shifting and risk distributing, and the fact that benefits are not ordinarily payable during the life of the insured.[73.2]

The 1984 Act now defines a life insurance contract as one which is a life insurance contract under applicable law, but only if it meets one of two tests.[74] The first test, the cash value accumulation test, is designed to allow traditional whole life contracts to accumulate interest at reasonable rates. A contract will meet the test if the contract shows that the cash surrender value at no time exceeds a hypothetical net single premium.[75] That net single premium would fund the future benefits on the date of measurement. This provision measures the cash surrender value as if it were a whole life limited payment premium which would cover the insured for the rest of his life.[76] It assumes that the fund accumulates interest at the greater of a rate of four percent or the rate

73. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 (adding I.R.C. § 7702(a)).

73.1. H.R. Rep. No. 432, 98th Cong., 2d Sess. 102 (1983).

73.2. *See* Helvering v. Le Gierse, 312 U.S. 531 (1941); Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978).

74. *Id.*

75. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 (adding I.R.C. § 7702(b)(1)).

76. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767-68 (adding I.R.C. § 7702(b)).

which is guaranteed under the contract.[77] The mortality charges are to be based on those specified in the contract. If none are specified, then the mortality charges are those which are used in determining the statutory reserves for the contract.[78] If additional benefits were available under the contract and the charges were specified for those benefits, then those charges are added to determine the net single premium amount. If the charges are not specified, however, nothing is added to the amount.[79] The death benefit is deemed not to increase.[80] If an endowment benefit is stated, then the amount of the benefit is deemed to be no greater than the least amount payable at any time under the contract.[81]

The alternative test is a guideline premium requirement with a cash value corridor.[82] A cash value corridor is simply the net amount at risk. A life insurance policy must have a certain net amount at risk throughout the life of the policy in order to remain classified as life insurance. Otherwise, the policyholder could pay a large premium amount early in the life of the policy so that his cash value would be high and the cost of insuring the risk of death would be low or nonexistent. By requiring the cash value corridor, the Code is allowing tax-free treatment on policies which resemble pure life insurance, and is denying tax-free treatment on those policies which resemble pure investment vehicles. The cash value corridor changes over the life of the policy to allow for a normal increase in cash value as the policy reaches maturity. Maturity is generally held to occur at age ninety-nine of the insured. As the insured reaches age ninety-nine, the opportunities for manipulation decrease.

The guideline premium is similar to the test under TEFRA.[83] A contract meets the test if the sum of the premiums paid does not at any time exceed the guideline premium at that time.[84] The guideline premium is the greater of the guideline single premium or the sum of the guideline level premiums as of the date of measurement.[85] Unless there are changes in the future benefits under the contract, the guideline single premium is determined at the

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77. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 (adding I.R.C. § 7702(b)(2)(A)).
78. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(c)(3)(B)).
79. *Id.*
80. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(e)(1)(A)).
81. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769 (adding I.R.C. § 7702(e)(1)(C)).
82. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 (adding I.R.C. § 7702(c)).
83. *See* I.R.C. § 101(f) (1982).
84. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 (adding I.R.C. § 7702(c)(1)).
85. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 (adding I.R.C. § 7702(c)(2)).

date of issue.[86] It would be that amount which is necessary to fund the benefits for the life of the contract. The mortality charges are those which are specified in the contract.[87] If none are specified, then the charges are those which are used in determining the statutory reserves under the contract.[88] The charges allowed also include any additional benefits if those benefits have charges stated in the contract. Otherwise, nothing is added because of the benefits.[89] Interest accumulated on the single premium amount is computed at the greater of six percent or the rates guaranteed under the contract.[90] A guideline level premium is based on annual payments which would be made to age ninety-five, at the greater of a rate of four percent or the rate guaranteed under the contract.[91]

A contract qualifies within the cash value corridor if the value at any time is not greater than an amount specified in the tables.[92] The cash value corridor applies to face value and ranges from 250% of cash value at age forty to 105% at age ninety. It is stated in five-year increments beginning at age forty through forty-five and ending at age ninety through ninety-five.[93]

The cash surrender value is determined without regard to any "surrender charge, policy loan, or reasonable termination dividend."[94] Therefore, the cash surrender value used for the computation is greater than it might be in reality. The term net surrender value is used to describe a cash surrender value adjusted for the surrender charge and the reasonable termination dividend.[95] The policy loan is not deducted.

The term future benefits includes both death benefits and endowment benefits.[95.1] The term qualified additional benefits includes benefits such as guaranteed insurability, accidental death or disability benefits, family term coverage, or disability waiver benefits. It also includes any other benefit prescribed under the regula-

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86. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(c)(3)(C)).
87. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(c)(3)(B)(i)).
88. *Id.*
89. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(c)(3)(B)(ii)).
90. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(c)(3)(B)(iii)).
91. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(c)(4)).
92. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(d)).
93. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 768 (adding I.R.C. § 7702(d)(2)).
94. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769 (adding I.R.C. § 7702(f)(2)(A)).
95. *See* Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769 (adding I.R.C. § 7702(f)(2)(B)).
95.1. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769 (adding I.R.C. § 7702(f)(4)).

tions.[96] The charges for these benefits are treated as future benefits. Any other benefit is not treated as a future benefit, and unless it is prefunded it is not treated as a premium.[97]

There is a provision allowing for the payment of a premium which exceeds the guideline premium amount if the premium is necessary to prevent the termination of the policy. The premium may not, however, exceed the amount necessary to prevent termination of the policy.[98] The transition rules under TEFRA were scheduled to expire on December 31, 1983. They have been extended, however, through 1984, and the new rules take effect in a limited way for nonflexible premiums beginning with any contract issued in 1984.[99]

VII. The Penalties

For any life insurance contract which does not meet the tests under the new law, the income on the contract will be taxed as ordinary income received or accrued during that year.[100] To calculate the income on the contract, it is necessary to combine the increase in net surrender value plus the cost of life insurance protection. This is measured during the taxable year.[101] This amount is in essence the benefit from which the policyholder must subtract the sum of any premiums paid during the taxable year. The income then is the excess of the benefit received over the premium paid. If the policyholder received a policy dividend, then the dividend is also added to the income. The cost of life insurance protection will be computed as the lesser of the amount stated in a mortality charge table or the amount stated in the contract.[102]

In any year during which the contract fails to meet the tests, the income from all prior taxable years will also be treated as accrued or received during that year. The income is treated as received during the year when the contract fails to meet the statutory tests.[103] Therefore, the policyholder is potentially liable for several years of accumulated income in one taxable year, even though he

96. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769-70 (adding I.R.C. § 7702(f)(5)(A)).
97. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769 (adding I.R.C. § 7702(f)(5)(B)).
98. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 770 (adding I.R.C. § 7702(f)(6)).
99. Pub. L. No. 98-369, § 221(b), 98 Stat. 494, 772 (amending I.R.C. § 101(f)(1)).
100. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 770-71 (adding I.R.C. § 7702(g)(1)(A)).
101. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 771 (adding I.R.C. § 7702(g)(1)(B)).
102. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 771 (adding I.R.C. § 7702(g)(1)(D)).
103. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 771 (adding I.R.C. § 7702(g)(1)(C)).

has not actually received the income. Thus, the provision imposes constructive receipt.

For any life insurance contract which does not meet the tests, the excess of death benefit over the net surrender value will be excluded from income of the beneficiary.[104] Therefore, the beneficiary will not incur federal income tax liability on the excess amount. A life insurance contract which becomes disqualified under the new provision remains an insurance contract and thus may be used in calculating other life insurance determinations.[105]

VIII. Taxation of Partial Surrenders

Partial surrenders are an integral feature of many new products, including universal life policies. Partial surrenders of a policy enable policyholders to withdraw cash value without forfeiting the entire policy. Under the new law, these partial surrenders may now be taxed.[106] The tax is based on the income within the contract, and the new law is effective for all policies purchased after December 31, 1984. Increasing death benefit contracts purchased after June 30, 1984, may also be covered.[107]

Under the new law, a partial surrender will generally reduce the future benefits under the contract.[108] This reduction of benefits will be treated as an exchange of one life insurance contract for another.[109] An exchange may occur tax free under the Code.[110] If cash or other property is received, however, then the cash or property must be recognized to the extent of gain within the contract.[111]

The effect of the new law should not apply to contracts issued prior to December 31, 1984, but the law is not clear. The legislative history indicates that Congress intended no such result.[112] Congress, however, has already given the Internal Revenue Service au-

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104. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 771 (adding I.R.C. § 7702(g)(2)).

105. Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 771 (adding I.R.C. § 7702(g)(3)).

106. Buechner, *A Threat To Life Insurance*, NATIONAL UNDERWRITER, Nov. 24, 1984, at 15. The surrender is treated as an exchange under I.R.C. § 1035 (1982), and the gain is taxed under I.R.C. § 1031(b) (1982). *See also* Dropick, *Life Insurance Exchanges Under Section 1035: Think Twice Before You Surrender*, 17 CONN. L. REV. 525 (1985) (§ 1035 has a broad effect beyond partial surrender).

107. *Id.*

108. *See* Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 769 (adding I.R.C. § 7702(f)(4)).

109. *See* I.R.C. § 1035 (1982).

110. I.R.C. § 1031 (1982).

111. I.R.C. § 1031(b) (1982).

112. H.R. REP. No. 432, 98th Cong., 2d Sess. 141-43 (1983).

thority to issue regulations prescribing annuity-like treatment for loans and withdrawals from a policy to the extent of income accumulated within the contract.[113]

CONCLUSION

The full effect of the new law has yet to be determined. The immediate effect, however, is to eliminate certain life insurance products from the market, or at least to diminish the attractiveness of those products so that they are no longer viable. Over the past thirty years, the life insurance industry has constantly developed new products in an attempt to meet the changing needs of the public.[114] Many of these new products have come from the newer, smaller, and more aggressive companies.[115] Thus, the competition from these newer and smaller companies has forced the older and larger companies to meet these competitive pressures. This competition among the companies has worked to the advantage of the insurance-buying public. For a variety of reasons, Americans do not plan adequately for their retirement, nor for the risk of premature death. Life insurance products offer both protection and forced savings. Universal life insurance is said to be the most promising new product in decades.[116] It is a viable alternative to the "buy term and invest the difference" strategy, in that it provides permanent insurance and a competitive investment.[117] While this product is still in the minority among all products offered and

113. *See* I.R.C. § 72(e)(5)(C) (1982). *See supra* note 12 for a discussion of the annuity-like treatment.

114. *See generally* Turner, *supra* note 48, at 12.

115. *Id. See Universal Life Insurance 1982, supra* note 46 for the leading companies now providing universal life products.

116. *Universal Life Insurance 1982, supra* note 46, at 12.

117. Two other significant advantages of universal life have also been proposed. First, since universal life contracts may be used in any application where traditional life insurance has been used, funding the buy-sell and stock redemption agreements is uniquely attractive for universal life. The values of a business and stock are likely to change over time. Universal life allows the policyholder to adjust his coverage without purchasing a new policy or forfeiting an old one. Second, in at least one state, Indiana, the cash value of a life insurance policy is protected against direct attachment by creditors. Ind. Code Ann. § 27-8-3-23 (Burns 1971). Therefore, a policyholder could shelter large amounts of cash within a universal life policy until needed and then withdraw amounts by a partial surrender without forfeiting the entire policy. *See* Shaw, *Universal Life, How It Works*, 71 ABA JOURNAL 68 (1985). In Georgia, state law does not protect premiums paid for insurance with intent to defraud creditors. The amounts so paid would inure to the benefit of creditors with interest thereon. O.C.G.A. § 33-25-11(b) (1982).

sold, it has caused major changes throughout the industry.[118] If new products such as this are allowed to evolve, then competitive forces will create even better products for the consumer in the future. If the government selectively removes the incentives from this new product as it has from similar ones in the past, then the older, larger companies will continue to prevail with policies which pay low rates of interest with the blessings of the government. The insurance-buying public would then return to the trend of buying only term insurance and attempt to seek out and manage their own investment opportunities. Many consumers possess neither the buying power nor the expertise to buy effectively in the investment market. At the same time, the need for permanent insurance will go unattended. When that need is finally realized, the cost of obtaining insurance may be too great.[119]

Therefore, the losers in this tax legislation are the newer, more aggressive life insurance companies and the insurance buying public.

Rex P. Cornelison III

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118. Universal life accounted for only 2.5% of the life insurance in force in 1982, but it accounted for 11.5% of the life insurance written in 1982. *Universal Life Insurance 1982*, *supra* note 116, at 12. There are 225 companies now writing some form of universal life. *See* TAX NOTES, *supra* note 47, at 63.

119. For an example of the escalation of premium rates with age of the insured, see *supra* note 20.