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Reflections on the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Life Insurance*

ANDREW D. PIKE**

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Investments made in the form of cash value life insurance have received preferential treatment under the income tax laws since 1913.¹ Most significantly, a policyholder does not include the interest credited under these contracts in current income.² If the life insurance contract remains in effect until the insured's death, the beneficiaries generally exclude from gross income the death benefits paid under the contract, including the previously untaxed interest.³

Although the favorable tax treatment of life insurance is of long standing, the Internal Revenue Code did not contain a comprehensive statu-

¹ The exclusion from gross income under § 101(a) for amounts paid due to the death of the insured originated in the Income Tax Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167. The exclusion has been reenacted in each succeeding act. See Revenue Act of 1916, ch. 463, § 4, 39 Stat. 756, 758; War Revenue Act of 1917, ch. 63, § 1200, 40 Stat. 300, 329; Revenue Act of 1918, ch. 18, § 213(b)(1), 40 Stat. 1057, 1065; Revenue Act of 1921, ch. 136, § 213(b)(1), 42 Stat. 227, 238; Revenue Act of 1924, ch. 234, § 213(b)(1), 43 Stat. 253, 267; Revenue Act of 1926, ch. 27, § 213(b)(1), 44 Stat. 9, 24; Revenue Act of 1928, ch. 852, § 22(b)(1), 45 Stat. 791, 797; Revenue Act of 1932, ch. 209, § 22(b)(1), 47 Stat. 169, 178; Revenue Act of 1934, ch. 277, § 22(b)(1), 48 Stat. 680, 687; Revenue Act of 1936, ch. 690, § 22(b)(1), 49 Stat. 1648, 1657; Revenue Act of 1938, ch. 289, § 22(b)(1), 52 Stat. 447, 458; IRC (1939), ch. 2, § 22(b)(1), 53 Stat. 1, 10; IRC § 101(a), 68A Stat. 3, 26.

Section 72(e) governs the tax treatment of surrenders of life insurance contracts. This section also traces its origins to the Income Tax Act of 1913. Under that act, all amounts received upon the surrender of a life insurance contract were excluded from income. Income Tax Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167. This provision was reenacted in succeeding acts. See Revenue Act of 1918, ch. 18, § 213(b)(2), 40 Stat. 1057, 1065. Section 213(b)(2) of the Revenue Act of 1926 limited this exclusion to the aggregate amount of premiums or other consideration paid for the policy. This limitation was reenacted in subsequent acts and continues to apply to amounts received upon the surrender of life insurance contracts. IRC § 72(e)(5). See Revenue Act of 1934, ch. 277, § 22(b)(2), 48 Stat. 680, 687; IRC (1939), ch. 2, § 22(b)(2), 53 Stat. 1, 10; IRC § 72(e) (5), 68A Stat. 3, 22.

² See IRC § 72(e). The precise statutory basis for this exclusion is obscure. See Hahn & Adney, *The New Federal Tax Definition of "Life Insurance Contract,"* 38 J. Am. Soc'y C.L.U. 40 n.4 (Nov. 1984); Manno, *The Federal Income Taxation of Life Insurance, Annuities and Individual Retirement Accounts After the Tax Reform Act of 1986,* 60 St. John's L. Rev. 674, 690 n.71 (1986). The exclusion has been questioned for some time. See, e.g., Paul, *Erosion of the Tax Base and Rate Structure,* 11 Tax L. Rev. 203, 210 (1956); Vickrey, *Insurance Under the Federal Income Tax,* 52 Yale L.J. 554, 563 (1943). If the contract terminates prior to the death of the insured, a portion of the interest theretofore credited under the contract may be includable in income at that time. See notes 48-51, 59-61 and the accompanying text.

³ IRC § 101(a)(1). The proceeds of the contract are not totally excluded from income if the contract is transferred for valuable consideration. See IRC § 101(a)(2); Gallagher, *A Primer on Section 101—Federal Income Taxation of Life Insurance Proceeds,* 49 Temp. L.Q. 831, 837-45 (1976). Amounts in the nature of interest paid to a beneficiary allocable to any post-death period are includable in gross income. IRC § 101(c), (d). A provision excluding from income up to \$1,000 of post-death interest paid on amounts held by the insurance company to the surviving spouse of the insured was repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1001(a), 100 Stat. 2085, 2387 [hereinafter sometimes cited as the 1986 Act].

tory definition of life insurance until the enactment of § 7702 in 1984.⁴ Before then, *Helvering v. LeGierse*⁵ expressed the common-law tax definition of life insurance. In *LeGierse*, the Supreme Court held that a contract qualifies as life insurance only if it involves both risk shifting and risk distribution.⁶ The Court's formulation required only that the contract contain some insurance risk; the magnitude of this risk was not material.⁷ This definition ultimately proved unacceptable to Congress because it permitted the development and marketing of "investment-oriented products that maximize the advantages of the deferral provided in the Code."⁸ Section 7702 was the response. This provision denies the tax benefits of life insurance to more investment-oriented contracts than "traditional" life insurance products.⁹ Contracts that satisfy § 7702's definition continue to enjoy the traditional favorable tax treatment, but, for those that do not, investment income credited is taxed currently.¹⁰

Debate concerning the proper tax treatment of life insurance investments has not abated. Notwithstanding the enactment of § 7702 in 1984, the preferential tax treatment of life insurance investments remained a prominent target of tax reform proposals. In 1985, President Reagan advocated full current taxation of interest credited under life insurance contracts.¹¹ By eliminating numerous tax preferences and imposing limitations on most other tax sheltered investments, the Tax Reform Act of 1986 caused increased attention to be focused on the unchanged treatment of life insurance investments.¹² In 1988, Congress enacted several modifications to the tax treatment of life insurance investments and ordered the Treasury Department and the General Accounting Office to study whether preferential treatment remains justified.¹³

⁴ H.R. Rep. No. 432, 98th Cong., 1st Sess., Vol. 1, 144 (1983) [hereinafter 1983 House Report]; S. Rep. No. 169, 98th Cong., 2d Sess., vol. 1, at 571 (1984) [hereinafter 1984 Senate Report].

⁵ 312 U.S. 531 (1941).

⁶ *Id.* at 539. See also Rev. Rul. 65-67, 1965-1 C.B. 56.

⁷ See Hahn & Adney, note 2, at 40-41.

⁸ 1983 House Report, note 4, at 102; 1984 Senate Report, note 4, at 523; see also K. Black & H. Skipper, *Life Insurance* 47-51, 68-76, 80-99 (11th ed. 1987); Hahn & Adney, note 2, at 41-43 (providing an overview of the development of life insurance products).

⁹ 1983 House Report, note 4, at 102; 1984 Senate Report, note 4, at 523.

¹⁰ See IRC § 7702(g); see also notes 84-89 and the accompanying text.

¹¹ The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity 254-57 (1985); see also 2 U.S. Dep't of Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* 258-61 (1984). Congress failed to enact this proposal.

¹² See U.S. General Accounting Office, *Taxation of Single Premium Life Insurance 1* (1987); Staff of Joint Comm. on Taxation, *Description of Possible Options to Increase Revenues* 223-24 (Comm. Print 1987); Insurance Industry Legislative Symposium, 1 *Ins. Tax Rev.* 1, 1-12 (March-April 1987); see also notes 226-27 and the accompanying text.

¹³ The Technical Corrections and Miscellaneous Revenue Act of 1988 [hereinafter sometimes referred to as the 1988 Technical Corrections Act], § 5012 alters the tax treatment of loans and other amounts received under "modified endowment contracts." In most circum-

This article analyzes and evaluates the preferential tax treatment of investment income earned under life insurance contracts satisfying the statutory definition of life insurance.¹⁴ Part I focuses on two tax policy questions. The first is whether justification exists for the preferential tax treatment of interest credited under cash value life insurance policies. Assuming adequate justification, the second question examined is whether § 7702 establishes appropriate limits on the range of life insurance contracts that qualify for preferential tax treatment.

Before addressing these questions, Part I provides an overview of the economic components of life insurance contracts. For many readers, the complexity of these arrangements operates as a barrier to analysis.¹⁵ This overview provides the basic analytic tools to enable a novice to proceed further. Following this discussion, Part I discusses the existing tax treatment accorded the owners of life insurance policies. Part I then examines the general actuarial limitations contained in § 7702's definition of life insurance. Part I concludes with an analysis of the current tax treatment of interest credited under cash value life insurance contracts and the tax policy decisions reflected in the general limitations incorporated in the statutory definition.

Part II of this article examines and evaluates the extraordinarily technical and arcane provisions of § 7702¹⁶ that are designed to prevent avoidance of its general actuarial limitations. First, Part II considers the

stances, a 10% penalty tax would apply to amounts included in income as a result of distributions from these contracts. *Id.* at § 5012(b). For contracts not classified as modified endowment contracts, the taxation of life insurance investments are, unchanged. This article does not discuss the definition of modified endowment contracts contained in IRC § 7702A.

In addition to changing the distribution rules applicable to modified endowment contracts, the 1988 Technical Corrections Act ordered the Treasury Department and the General Accounting Office to study the "policy justification for, and the practical implications of, present-law treatment of the earnings on the cash surrender value of life insurance and annuity contracts in light of the Tax Reform Act of 1986." 1988 Technical Corrections Act § 5014(a).

Several other proposals for reform have been suggested. Congressmen Stark and Gradison proposed more sweeping changes in this area. See H.R. 3441, 100th Cong., 1st Sess., 133 Cong. Rec. H8289-90 (Oct. 7, 1987). Under H.R. 3441, most pre-death distributions from life insurance contracts would be taxed in the same fashion as distributions from annuity contracts. The General Accounting Office suggested several alternatives that focused on policy loans from single premium life insurance contracts. See *Taxation of Single Premium Life Insurance*, note 12, at 30-34.

¹⁴ This article does not examine the exclusion of mortality gains from income under § 101(a). For a life insurance contract, the mortality gain represents the portion of the death benefit that exceeds the sum of the policyholder's investment in the policy and the net amount of interest credited under the policy during the insured's life. Although mortality gains under life insurance contracts are excluded from gross income, mortality gains received in connection with annuity contracts are subject to tax. IRC § 72(b)(2).

¹⁵ See Vickrey, note 2, at 560 n.14.

¹⁶ A commentator has noted that the language of the Internal Revenue Code governing life insurance products "sometimes appears to have been co-authored by James Joyce and Casey Stengel." Manno, note 2, at 674.

provisions of § 7702 that limit the actuarial assumptions used upon the issuance of a policy. Part II then explores the difficulties that arise when modifications to a life insurance contract occur after the contract is issued. Section 7702's limitations are based on the original terms specified in the life insurance contract. The adjustment rules seek to maintain the general constraints on investment orientation in light of changed contractual terms. Finally, Part III contains conclusions and suggestions for legislative change.

I. TAXATION OF CASH VALUE LIFE INSURANCE FOLLOWING THE ENACTMENT OF SECTION 7702

A. *A Primer on Life Insurance Economics*

Individuals are often concerned that the loss of income resulting from their death may leave their families with inadequate financial resources to maintain an acceptable standard of living. Through the purchase of a life insurance contract, an individual shifts this financial risk to a life insurance company. If the insured dies while the contract is in effect, the policy's beneficiaries receive a specified dollar amount. This payment of a specified death benefit to a beneficiary constitutes one of the defining characteristics of life insurance.¹⁷ Following the insured's death, investment of the contractual death benefit may generate income to replace a portion of the income previously generated by the insured's efforts.¹⁸

A life insurance company charges an amount called the premium to compensate it for assuming this economic risk.¹⁹ The premium reflects the costs that the life insurance company anticipates it will incur as a result of assuming the risks in question. These expenses include the cost of current insurance protection, which in turn depends on the likelihood that the insured risk will occur.²⁰ In general, the cost of current insur-

¹⁷ K. Black & H. Skipper, note 8, at 13.

¹⁸ *Id.* at 201-21. Life insurance is purchased for a variety of purposes besides protecting one's family. For example, a creditor may insist that a debtor maintain a policy of life insurance with a death benefit sufficient to satisfy the amount of indebtedness. *Id.* at 264-65. In addition, a business may purchase insurance on the life of a shareholder to provide a source of funds to purchase stock owned at the time of the shareholder's death. *Id.* at 265-71.

¹⁹ Richey, *Life Insurance: The Investment of Your Life (How to Pick What is Best for the Client)*, 41 N.Y.U. Inst. Fed. Tax'n 33-1, 33-55 (1983).

²⁰ See K. Black & H. Skipper, note 8, at 17-18. Although the a priori likelihood that any particular individual will die during a given year is impossible to determine, the expected mortality rate of a large group is much more predictable. *Id.* at 14. Insurers use the actual mortality experience of large populations to construct mortality tables. *Id.* at 313-17. A mortality table indicates the probability that an individual of a given age will die during the next year. In computing premiums, a life insurance company may modify a standard mortality table to reflect mortality differences between its customers and the larger population. *Id.* at 317. For example, the premiums for nonsmokers who exercise regularly should reflect their favorable mortality experience. The company's expected cost of insurance protection equals the death

ance protection represents a small percentage of the death benefit because the likelihood that an individual will die during a particular year is relatively small.²¹ The cost of current insurance protection, however, is not the sole factor that affects premium rates. Other factors include the benefits (other than the death benefit) promised under the contract and the income that the life insurance company expects to earn through the investment of the premium dollars received.²²

1. *Term Life Insurance*

Term life insurance provides current insurance protection for a limited time.²³ As with all forms of life insurance, the insurance company pays the specified death benefit if the insured dies during the period of coverage. If the insured outlives the policy term, however, the insured and the designated beneficiaries have no further economic claims against the life insurance company. Term life insurance that is renewable yearly is the most common form of term life insurance currently sold.²⁴

Although the premium charged for a term policy is based primarily on the probability of the insured's death during the period of coverage, the life insurance company earns investment income from the time that it receives the premium until it pays any death benefits to policy beneficiaries.²⁵ To the extent that the anticipated investment earnings offset

benefit specified in the policy multiplied by the likelihood of the insured's death during the year in question, as determined under the applicable mortality table. *Id.* at 18.

²¹ *Id.* According to the 1980 Commissioners' Standard Ordinary Mortality Table, there is less than a 10% likelihood that an individual aged 80 will die during the next year; for an individual aged 50, the likelihood is less than 1%. *Id.*

²² *Id.* at 16-18. Premiums typically include a "load" factor that reflects the life insurance company's operating expenses and anticipated profits. Richey, note 19, at 33-48. For purposes of illustrating the economics of life insurance contracts, loading charges are ignored as an unnecessary complication. The loading charges are considered, however, in the discussion of the appropriate tax treatment of the policyholder. See notes 59-63 and the accompanying text. Loading charges also affect § 7702's limitations on premiums paid. See IRC § 7702(c)(3)(B)(ii).

²³ Richey, note 19, at 33-60.

²⁴ K. Black & H. Skipper, note 8, at 54. Yearly-renewable term life insurance policies guarantee that the insured may renew the policy even if the insured's health has deteriorated to the point that insurance is otherwise unobtainable. *Id.* at 17. Although this guarantee provides a very limited form of insurance protection against changes in one's health, this article treats yearly-renewable term insurance as pure term life insurance. The presence of the renewal feature increases the cost of the policy.

²⁵ *Id.* at 18; see also Neubig & Steuerle, *The Taxation of Income Flowing Through Financial Institutions*, U. S. Treasury Dep't Office of Tax Analysis Paper 52, at 4-5 (Sept. 1983). Although an insurance company's sources of investment income are varied—real estate mortgages, equity securities, bonds, and other financial instruments—this article generally refers to the insurer's earnings as "interest."

There is no explicit mechanism to provide for the crediting of interest in most term life insurance policies. Interest may be reflected, however, in the price charged for the term insurance. K. Black & H. Skipper, note 8, at 18.

the cost of current insurance protection in determining the term premiums charged, the purchaser receives the same economic benefit as if interest were paid by the life insurance company. It is difficult to isolate the amount of interest applied for the purchaser's benefit because neither the cost of current insurance protection nor the amount of interest is known.²⁶ Given this practical problem, as well as the likelihood that the interest credited is modest in amount, it is reasonable to view one-year term life insurance as having no savings component.²⁷

The linkage between the probability of the insured's death and the premium charged causes term insurance premiums to increase as the age of the insured increases.²⁸ For many years, the prospect of constantly rising premiums limited sales of term life insurance.²⁹ Following the 1950's, however, term insurance has gained a larger share of the life insurance market,³⁰ although this trend may have been reversed in the 1980's.³¹

²⁶ In arithmetical terms, the term premium equals: (1) the cost of insurance protection, plus (2) loading charges, less (3) the amount of interest implicitly credited. Unless the values of three variables are known, the fourth variable is indeterminate. The only known value is the term premium. Absent information concerning the magnitude of the cost of insurance protection and the loading charges, the interest credited cannot be isolated.

²⁷ See Neubig & Steuerle, note 25, at 5; Goode, *Policyholders' Interest Income From Life Insurance Under the Income Tax*, 16 Vand. L. Rev. 33, 36-37 (1962). The amount of interest credited depends on the size of the premium and the period during which the premiums are invested. For one-year term policies, the insurance company has the use of the premiums for less than one year because death benefits are paid throughout the year. Moreover, term premiums tend to be modest. For example, a \$100,000 one-year term policy for a 35-year-old person is likely to cost less than \$300. See K. Black & H. Skipper, note 8, at 54. For such a contract, the interest credited will not exceed the return realized when a modest amount (i.e., less than \$300) is invested for less than one year. If the term of the policy extends for several years, the interest credited may become significant. See Irenas, *Life Insurance Interest Income Under the Federal Income Tax*, 21 Tax L. Rev. 297, 304 (1966).

²⁸ K. Black & H. Skipper, note 8, at 18; Irenas, note 27, at 299.

²⁹ See Irenas, note 27, at 299 & n.11.

³⁰ K. Black & H. Skipper, note 8, at 51-52. See also American Council on Life Insurance, *1986 Life Insurance Factbook* 13 [hereinafter *Life Insurance Factbook*].

³¹ Term contracts accounted for 60% of the aggregate coverage under newly issued life insurance contracts in 1982, but only 38% in 1985. *Life Insurance Factbook* at 13. The cause of this decline in market share is unclear. One factor may have been the increased sales of universal life insurance which, in 1985, accounted for approximately 40% of new individual life insurance purchases. *Id.* at 12, 13. One possibility is that the increased volume of nonterm contracts can be traced, in large part, to the replacement of a substantial number of existing cash value life insurance policies with universal life policies. This replacement scenario would explain the discrepancy between the substantial decline in term insurance's market share and the much more modest decline in the portion of life insurance in force consisting of term contracts. From 1981 to 1985, this share declined from 38.5% to 37.0%. *Id.* at 27.

The use of universal life insurance as a substitute for existing cash value contracts would not be surprising. Universal life insurance was developed in the late 1970's to overcome features that reduced the marketability of other forms of cash value life insurance. See Comment, *TEFRA's Conversion of Universal Life Insurance Into the Flexible Premium Life Insurance Contract*, 3 J.L. & Com. 325 (1983); Comment, *Federal Taxation of Life Insurance Products After the Tax Reform Act of 1984*, 1 Ga. St. U.L. Rev. 237, 245-48 (1985). The differences

2. *Cash Value Life Insurance Policies*

The second major type of life insurance is "cash value" life insurance, so called because, in addition to providing a specified death benefit upon the death of the insured, these policies create a cash value during the insured's life.³² The cash value is the amount that the policyowner receives if the policy is cancelled.³³ The accumulation of cash value reflects the existence of a savings feature in this form of insurance.³⁴

The prototypical form of cash value life insurance is the level-premium, "whole" life insurance policy.³⁵ In this type of policy, a fixed premium is charged annually for the remainder of the insured's life. The premium remains constant notwithstanding the increasing likelihood of death. During the early years of the contract, the premium paid exceeds the cost of current insurance protection.³⁶ The life insurance company invests this excess which, together with any investment income earned, can be used for two purposes. First, it can supply the funds to pay benefits under the contract in later years.³⁷ Second, the accumulated balance serves as the basis for computing the policy's cash value.³⁸

between traditional and universal life insurance are discussed in notes 136-41 and the accompanying text.

³² Cash value life insurance includes a variety of life insurance products including "whole" life insurance, single premium life insurance, universal life insurance, and variable life insurance. Although there are important differences among these life insurance products, the economic significance of the cash values is the same for these types of policies.

³³ See K. Black & H. Skipper, note 8, at 355-64. Cash value is also called the surrender value of the contract. Upon the surrender of a policy, the life insurance company must pay to the policyholder an amount no less than the minimum amount mandated under the applicable nonforfeiture law. The cash value, however, may exceed these mandated minimums. *Id.* at 362.

³⁴ See 2 U.S. Dep't of Treasury, *Tax Reform For Fairness, Simplicity, and Economic Growth* 258 (1984); Vickrey, note 2, at 560-61; Goode, note 27, at 34-37; Irenas, note 27, at 299-304; McLure, *The Income Tax Treatment of Interest Earned on Savings in Life Insurance*, 3 *The Economics of Federal Subsidy Programs—A Compendium of Papers Submitted to the Joint Economic Committee* 370, 374 (1972). Defenders of the existing tax treatment of life insurance investments assert that compartmentalization of cash value life insurance into savings and insurance components "is based on a faulty concept of level premium life insurance. [I]t is a product that provides lifetime insurance protection at a level premium, thereby avoiding sharp premium increases as one gets older." See Schweiker, *Guest Editorial: Proposal to Tax Life Insurance Would Damage the Financial Security of Millions of Americans*, 39 *J. Am. Soc'y C.L.U.* 11 (Sept. 1985).

³⁵ See K. Black & H. Skipper, note 8, at 23; Irenas, note 27, at 299.

³⁶ K. Black & H. Skipper, note 8, at 23.

³⁷ *Id.* at 19. In many instances, the amount accumulated equals the life insurance company's reserve liability for the policy. *Id.* at 345-46. A life insurance reserve represents an actuarial present value estimate of the company's liability under a policy. This estimate depends primarily on assumptions concerning three variables: (1) the cost of current insurance protection; (2) the rate of interest credited; and (3) the method used to amortize expenses incurred under the policy. *Id.* at 349-53.

³⁸ *Id.* at 355-64.

To illustrate the generation of cash value under a level-premium contract, consider a simplified hypothetical contract with a death benefit of \$100,000 issued to a 35-year-old individual. The annual premium for this contract is \$1,279.³⁹ During the first year, the premium of \$1,279 is applied to pay the cost of current insurance protection, which is \$208.⁴⁰ The remaining \$1,071 earns interest at a 4% rate, or \$47, during the first year,⁴¹ thereby building the cash value to \$1,117.⁴² The \$47 of interest credited is commonly called "the inside interest build-up" of a life insurance policy.

In the second year, payment of the annual premium increases the cash value. As in the first year, the charge for current insurance protection reduces the cash value. The insurance company's net amount at risk, however, is no longer the full \$100,000 death benefit.⁴³ The cash value of \$1,117 reduces the net amount at risk to \$98,883. Consequently, the mortality charge imposed under the contract is based on the net amount at risk of \$98,883. Similarly, in subsequent years, the policy's cash value increases, while the amount of current insurance protection declines.⁴⁴

³⁹ This example incorporates the methodology developed by the Treasury Department for analyzing life insurance investments. See *Tax Treatment of Life Insurance Companies*, Hearings before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means, 98th Cong., 1st Sess. 12-14, 27 (1983) (statement of John E. Chapoton, Ass't Secretary, Dep't of Treasury) [hereinafter 1983 Hearings]. The actuarial assumptions used in this example are as follows: interest is credited at a 4% rate; and mortality charges are based on the 1980 Commissioners' Standard Ordinary mortality table. To simplify the discussion, no load is added to the premium, i.e., the premium is not increased to reflect expenses or profits. Similarly, no surrender charge is imposed under this policy.

⁴⁰ This amount represents the insurance company's charge for assuming the insurance risk. Table 1 in the Appendix illustrates the generation of cash value under this contract. For each year that the contract remains in force, Table 1 indicates the premium paid, the cost of current insurance protection under the contract, the interest credited, and the cash value of the contract as of the end of the year. These calculations assume that the mortality charges are imposed in the middle of each policy year.

⁴¹ In this example, interest is credited at a 4% rate. Under the terms of a traditional level-premium policy, interest is not credited explicitly. One can determine the implicit rate of interest if the premium level, the mortality charges imposed, and the cash values over the life of the contract are all known. When neither the interest rate nor mortality charges are separately stated, however, it is not possible to determine the implicit interest rate. See J. Belth, *Life Insurance: A Consumer's Handbook* 50-53 (1985); cf. Tobias, *The Invisible Banker* 259 (1982) (stating that ascertaining both the interest rate and the mortality charge is as difficult as determining the separate cost of the macaroni and the cheese when they are bought for a single price of \$1.39).

During the late 1970's and early 1980's life insurance companies began to credit interest at higher rates. See K. Black & H. Skipper, note 8, at 77-79. More recently, life insurance companies have developed contracts which explicitly credit interest to the policyholder. *Id.* at 68-74; see also note 110.

⁴² The cash value as of the end of any year = opening cash value + premium - cost of current insurance protection + interest credited.

⁴³ See K. Black & H. Skipper, note 8, at 25.

⁴⁴ Although the current insurance protection declines, the mortality charges may increase due to the increasing probability of death as the insured ages.

This level-premium contract illustrates the basic components of all cash value life insurance policies: the premium, the charges imposed for current insurance protection, the interest credited, and the cash value. The precise relationship among these components depends, however, on the level of current insurance charges, the rate at which interest is credited, and the pattern and magnitude of the premium payments. For example, decreases in the charges for current insurance protection cause the cash value (and the interest credited thereon) to increase. Similarly, an increase in the rate of interest credited causes the cash value to increase at a more rapid rate, thereby reducing the amount of, and charges for, current insurance protection at a more rapid rate.

Examination of a \$100,000 single-premium life insurance contract issued to a 35-year-old individual illustrates the complex interaction among the economic components of cash value life insurance.⁴⁵ The single premium for this contract is \$25,188; no additional premiums are payable. The death benefit remains at \$100,000. In comparison to the level-premium contract discussed previously, in every year the single-premium contract generates higher levels of cash value and credits more interest. The larger cash values reduce the amount and the cost of current insurance protection.

The differences between the level-premium contract and the single-premium contract (both having a \$100,000 death benefit) during the first year are summarized as follows:

	<u>Level Premium Contract</u>	<u>Single Premium Contract</u>
Yr 1: Premium	\$1,279	\$25,188
— Cost of Insurance Protection	(208)	(158)
+ Interest Earned	47	1,004
= Closing Cash Value	1,117	26,034
Yr 2: Current Insurance Protection	98,883	73,966

The cash value generated in a life insurance contract has many of the attributes of a financial asset.⁴⁶ While the cash value remains with the life insurance company, it is credited with interest. In addition, the policyholder can obtain the cash value either by terminating the policy or, if the policyholder desires to keep the contract in effect, by borrowing the cash value from the insurance company.⁴⁷ Notwithstanding the similari-

⁴⁵ See Appendix, Table 2.

⁴⁶ See J. Belth, note 41, at 56-58.

⁴⁷ See K. Black & H. Skipper, note 8, at 56-58, 119-22. The borrowing of a contract's cash value creates a formal obligation to repay the amount borrowed, plus interest. There are sev-

ties between the cash value of a life insurance contract and other financial instruments, there is one distinguishing characteristic of cash value life insurance: The cash value pays the costs of current insurance protection.

B. Current Tax Treatment of the Policyholder

The investment income credited to the cash value of life insurance contracts receives unusually benevolent treatment under the income tax laws. As discussed above, the increase in the cash value of a life insurance contract consists, in part, of interest or other investment returns that the life insurance company credits to the policy's cash value.⁴⁸ The tax treatment of this interest credited differs from the tax treatment of other forms of interest in three significant respects. First, taxation of the interest is deferred. Second, the income measurement rules cause a portion of the interest credited to escape taxation. Third, § 101(a) generally excludes the remaining interest from gross income if the policy remains in force until the death of the insured. Each of these benefits is discussed below.

eral alternative means available to the policyholder to satisfy this debt. For example, the policyholder may cancel the life insurance contract during the insured's life, in which case the contract's surrender value is applied to the unpaid liability. Moreover, if the loan remains outstanding at the time of the insured's death, the loan balance offsets a portion of the death benefit otherwise payable to the contract's beneficiaries. *Id.* at 119-20.

The life insurance contract treats the policy loan as a bona fide loan, rather than a withdrawal of the contract's cash value. For this reason, the life insurance company credits interest on the full cash value rather than the unborrowed sum remaining with the company. Similarly, interest is payable to the life insurance company on the full amount of the policy loan. Life insurance contracts issued prior to the late 1970's generally specified a fixed (and modest) rate of interest payable on a policy loan. Contracts issued more recently link the interest rate payable on loans to the interest rate applied to the contract's cash value.

⁴⁸ See notes 32-45 and the accompanying text. In the cash value life insurance contracts discussed previously, interest was credited to the cash value at a 4% rate. See note 39. An interest earning fund, however, is not the only type of investment available under cash value life insurance. Through the use of either a variable life or a variable universal life insurance policy, a policyholder can acquire indirect investments in stocks, bonds, money market funds, and real estate. Premiums for these forms of life insurance exceed the cost of the current insurance protection and the load charges during the early years of the policy. The remaining portion is invested in a separate investment account similar to a mutual fund. The cash value of these policies reflects the investment performance of the underlying fund assets. See K. Black & H. Skipper, note 8, at 68-71, 96-97.

The amount credited to the cash value of a variable life insurance policy reflects the income earned by, and changes in the value of, the underlying fund assets. See *id.* at 68-69; IRC § 817(d). Whether the income credited to the cash value constitutes interest, dividends, realized gains, rents, or some other form of income depends on the assets of the fund. For purposes of this article, the term "interest credited" includes any investment return that is credited to the cash value of a life insurance contract.

1. *Tax Deferral Benefits*

A primary tax benefit resulting from the ownership of cash value life insurance relates to the timing of taxation: While the policyholder allows the cash value to accumulate, no portion of the interest credited to the cash value is included in gross income.⁴⁹ Further deferral results from the operation of the "stacking rule" applicable to life insurance contracts other than "modified endowment contracts."⁵⁰ This stacking rule characterizes a cash distribution from a life insurance contract either as a nontaxable return of the policyholder's capital or as taxable interest credited. Under the general life insurance stacking rules, a policyholder who withdraws cash (other than from a modified endowment contract) excludes from income the amounts received until the aggregate amount received exceeds the policyholder's investment in the contract.⁵¹ As a result, taxation of the interest credited under a cash value life insurance contract is deferred until the policyholder converts a substantial portion of the cash value into cash.

A policyholder can extend the period of deferral, and receive cash in excess of his investment, by borrowing the cash value of the policy from

⁴⁹ See note 2. Even if a contract is characterized as a "modified endowment contract" under § 7702A, interest credited is not taxable until a distribution occurs. Although a life insurance company includes in its gross income all investment income earned, it is allowed an offsetting deduction for the amount credited to the cash value. See IRC §§ 803, 807(b), (d). Consequently, the life insurance company is not taxed on the investment income credited in lieu of current taxation of the policyholder.

⁵⁰ IRC § 72(e)(1)(A), (e)(5). Section 72(e) applies to amounts received under annuity, life insurance, or endowment contracts that are not received as annuities. The general stacking rule under this section states that distributions are includable in income to the extent that the cash value exceeds the policyholder's investment in the contract. IRC §§ 72(e)(2), (3). A special stacking rule applicable to life insurance contracts, however, allows the policyholder to exclude distributions from gross income until the policyholder receives an amount equal to the cumulative premiums theretofore paid. IRC § 72(e)(5)(A), (C)(6). The policyholder includes in income all additional amounts received. *Id.* The 1988 Technical Corrections Act added § 72(e)(10), which applies the "income out first" annuity stacking rules to life insurance contracts characterized under § 7702A as "modified endowment contracts."

To a limited extent, the annuity stacking rules also apply to cash distributed from a life insurance contract incident to a reduction in benefits occurring during the 15-year period following issuance of the contract. IRC § 7702(f)(7)(B); see notes 380-91 and the accompanying text. Similarly, boot received incident to an exchange of life insurance contracts is subject to stacking rules that are similar to the annuity stacking rules. See notes 57-58 and the accompanying text.

The annuity stacking rules of § 72(e)(1)(A) also apply to life insurance contracts with respect to which, under Treasury regulations, "the amount at risk . . . is sufficiently minimal." IRC § 72(e)(5)(C), S. Rep. No. 494, 97th Cong., 2d Sess. 351 (1982). The Treasury has not issued regulations under this provision. The extent to which the Treasury's regulatory authority in this area survives the enactments of § 7702 and § 72(e)(10) is unclear.

⁵¹ IRC § 72(e)(5)(A), (C). But see § 72(e)(10), which treats cash distributions from modified endowment contracts as income to the extent that the contract's predistribution cash value exceeds the policyholder's investment in the contract.

the life insurance company.⁵² Loans secured by life insurance contracts (other than modified endowment contracts) are not treated as distributions.⁵³ Although interest is payable on most policy loans, the policyholder incurs minimal after-tax costs in connection with this type of indebtedness because the cash value used as the "collateral" continues to earn interest. The policyholder's pretax "cost" of borrowing equals the difference between the interest payable on the loan and the interest credited to the allocable amount of cash value. This difference, typically, is small.⁵⁴ If interest paid on the policy loan is deductible, borrowing may produce an after-tax profit for the policyholder.⁵⁵ Thus, if the pol-

⁵² A policyholder is generally entitled to borrow a substantial portion of the cash value of a policy without the approval of the insurance company. Although interest is payable on the amount borrowed, the failure to pay interest will not result in the policyholder's default. Instead, the unpaid interest is added to the principal of the loan unless the total indebtedness equals or exceeds the cash value of the policy. K. Black & H. Skipper, note 8, at 139-41. The life insurance company will recover any balance the policyholder owes on the loan from the death benefits if the loan remains outstanding on the insured's death, or from the cash value if the policy is terminated during the insured's life. J. Belth, note 41, at 119-20.

⁵³ See *Drake v. United States*, 597 F. Supp. 1271 (D.N.C. 1984); *Minnis v. Commissioner*, 71 T.C. 1049 (1979). Loans under, or secured by, an annuity, a modified endowment contract or a qualified employer plan are treated as taxable distributions. IRC § 72(e)(4)(A), (e)(10), (p).

⁵⁴ See K. Black & H. Skipper, note 8, at 79, 139-40. Some life insurance contracts provide "no net cost" policy loans. The interest rate charged on a no net cost loan equals the rate of interest credited to the cash value.

⁵⁵ See C. Steuerle, *Taxes, Loans, and Inflation 57-72* (1985). Although the taxpayer pays interest on the indebtedness incurred, the interest credited to the cash value of the policy is not taxable currently. Where the tax saving attributable to the interest deduction exceeds the difference between the interest paid and the increase in the cash value, the cost of borrowing is negative. Therefore, the taxpayer enjoys an after-tax profit.

The deductibility of interest paid on a policy loan is determined first according to the general rules applicable to interest. See *Salley v. Commissioner*, 55 T.C. 896, 903 (1971), *aff'd*, 464 F.2d 479 (5th Cir. 1972). Although interest payments are generally deductible (IRC § 163(a)), several limitations may result in the disallowance of the deduction. For noncorporate policyholders, the deduction for interest paid is subject to the limitations imposed on investment interest and personal interest. IRC § 163 (d), (h); see also Manno, note 2, at 677-81 (discussing the effect of the § 163(h) limitations on policy loans).

Additional limitations apply to interest paid on loans related to certain life insurance contracts. IRC §§ 264(a)(2)-(4). The interest deduction is disallowed if the loan is incurred or continued in connection with a single premium policy. IRC § 264(a)(2), (b). The disallowance also applies to interest "paid or accrued on indebtedness incurred or continued to purchase or carry" a life insurance contract. IRC § 264(a)(3). For policies that are not treated as single premium policies, the disallowance provision applies only if two further conditions are satisfied. First, the indebtedness must arise pursuant to a plan of purchase that contemplates the systematic borrowing of increases in the contract's cash value. IRC § 264(a) (3). Second, the indebtedness must not be of a type included in the safe harbors of § 264(c).

For certain taxpayers engaged in a trade or business, an additional limitation may apply. No deduction is allowed for interest paid on loans in excess of \$50,000 per insured individual under contracts insuring the lives of officers, employees, or any individual who is financially interested in any trade or business of the taxpayer. IRC § 264(a)(4).

icy loan is treated as a bona fide indebtedness,⁵⁶ the loan proceeds are not characterized as an amount "received" for purposes of the stacking rules contained in § 72(e). Consequently, policy loans extend the tax deferred status of interest credited to cash value at little cost to the policyholder. The combined effect of the income deferral allowed under § 72(e) and the availability of policy loans often results in the interest credited under cash value life insurance (other than modified endowment contracts) escaping taxation until the policy terminates.

Nonrecognition of gain realized in a like-kind exchange subject to § 1035 provides another mechanism that may extend the period of tax deferral. A policyholder may become dissatisfied with an existing life insurance contract, most commonly because he believes that a new policy will provide the same benefits at less cost.⁵⁷ When a policyholder exchanges a cash value life insurance policy for a new policy, no amount is included in income unless "boot" is received.⁵⁸

2. *Understatement of Income*

Owners of cash value life insurance enjoy a second lifetime tax benefit: Taxable income, when realized, systematically understates the amount of interest income credited under the policy. As discussed above, the cost of current insurance protection and the loading charges are subtracted from the interest credited in computing changes in the policy's cash value.⁵⁹ If a policyholder surrenders a contract, the amount includable in income equals only the excess of the amount received (the cash value of the policy) over the investment in the contract.⁶⁰ The interest credited under the contract exceeds the amount included in the policyholder's income by the cumulative amount charged for loading and current insurance costs. In effect, the policyholder deducts the cost of current insurance protection⁶¹ which is otherwise a nondeductible personal expense of the policyholder.⁶²

⁵⁶ See *Mose & Garrison Siskin Memorial Found. v. United States*, 790 F.2d 480, 482-83 (6th Cir. 1986) (treating policy loans as indebtedness and not as advances of amounts otherwise payable in the future); *Salley v. Commissioner*, 55 T.C. 896, 903 (1971), aff'd, 464 F.2d 479 (5th Cir. 1972) (same). See also *Dean v. Commissioner*, 35 T.C. 1083 (1961) (treating policy loans as secured nonrecourse indebtedness for purposes of the interest deduction). None of these cases considered no net cost policy loans.

⁵⁷ K. Black & H. Skipper, note 8, at 180-82.

⁵⁸ IRC §§ 1035, 1031; see generally Dropick, *Life Insurance Exchanges Under Section 1035: Think Twice Before You Surrender*, 17 Conn. L. Rev. 525 (1985).

⁵⁹ See notes 39-42 and the accompanying text.

⁶⁰ IRC § 72(e)(5).

⁶¹ See 1983 Hearings, note 39, at 38 (statement of Ass't Secretary Chapoton); Irenas, note 27, at 312.

⁶² See Reg. § 1.262-1(b)(1) (characterizing premiums paid for life insurance as a personal expense). In some circumstances, the cost of insurance protection may be an ordinary and

Similarly, to the extent that loading charges are allocable either to the provision of insurance protection or to investment management services, the policyholder may enjoy a similar benefit. This benefit is placed in perspective by examining the tax consequences that would result if the policyholder were to pay a smaller premium, invest the difference, and pay the investment earnings to the insurance company in lieu of the loading charges. The investment earnings would be included in the policyholder's gross income. In most instances, however, no offsetting deduction would be allowed for the payment to the insurer.⁶³ Understating the income realized on the surrender of a life insurance contract effectively allows the policyholder to deduct these expenses against the interest credited to the contract's cash value.

3. Forgiveness of Tax Upon the Death of the Insured

The third tax benefit accorded owners of cash value life insurance is that the interest income not taxed previously is exempted from taxation upon the death of the insured. The death benefit consists of both the cash value of the policy as of the insured's death and the net amount at risk under the policy. In general, amounts payable on account of the insured's death, including that portion representing the accumulated cash value, are excluded from income.⁶⁴

C. Section 7702 General Actuarial Limitations

1. Section 7702: An Overview

Section 7702 was enacted as part of the Tax Reform Act of 1984.⁶⁵ It contains the Code's first comprehensive statutory definition of life insurance.⁶⁶ Two related developments sparked congressional interest in this definition. First, the tax status of certain novel designs of cash value life

necessary expense of the policyholder. For example, amounts paid for insurance required to obtain a business loan is a business expense. No deduction is allowed, however, for life insurance premiums paid in connection with the taxpayer's trade or business if the taxpayer is a direct or indirect beneficiary of the contract. See IRC § 264(a)(1); Reg. § 1.264-1.

⁶³ See IRC §§ 67, 262.

⁶⁴ IRC § 101(a)(1); see note 3 (discussing the scope of the exclusion under § 101). The exclusion of death benefits from income is limited in instances where the policy is transferred for value. Few contracts are subject to this transfer for value rule. Irenas, note 27, at 309-10.

⁶⁵ Tax Reform Act of 1984, Pub. L. No. 98-369, § 221(a), 98 Stat. 494, 767 [hereinafter sometimes cited as the 1984 Act].

⁶⁶ 1983 House Report, note 4, at 144; 1984 Senate Report, note 4, at 571. IRC § 101(f), as added by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 266(a), 96 Stat. 324, 547, established criteria that determine when § 101 excludes from gross income death benefits paid to beneficiaries of flexible premium life insurance contracts issued prior to January 1, 1985. The provisions of § 101(f) served as the foundation for the more comprehensive definition of life insurance contained in § 7702. 1983 House Report, note 4, at 145; 1984

insurance contracts, including universal life insurance,⁶⁷ needed resolution.⁶⁸ Second, life insurance companies marketed new products that maximized the investment features of life insurance while minimizing the amount of current insurance protection.⁶⁹ Congress defined life insurance in § 7702 in response to these concerns.⁷⁰ This definition eliminated uncertainty as to the tax status of various life insurance products while denying life insurance status to some that were considered overly investment oriented.

Although Congress recognized the preferential tax treatment accorded life insurance,⁷¹ it did not alter any of the basic rules governing this form of investment. The thrust of the legislation was to distinguish what Congress termed "traditional" uses of life insurance from "investment-oriented products."⁷² Uses of life insurance which satisfy the requirements of § 7702 continue to receive preferential tax treatment.

Section 7702 adopts two alternative limitations to identify overly investment-oriented contracts. These limitations are the cash value accumulation test⁷³ and the guideline premium limitation.⁷⁴ These limitations, which permit investment orientation comparable to that allowed under the single-premium contract design discussed above, repre-

Senate Report, note 4, at 572; see also Hahn & Adney, note 2, at 41-42 (discussing the background and application of IRC § 101(f)).

⁶⁷ See K. Black & H. Skipper, note 8, at 80, 85-93. As discussed in notes 136-41, the most significant innovations incorporated in universal life insurance contracts are: (1) the greater flexibility given the policyholder to choose the amount and timing of the premium payments; (2) the crediting of more competitive rates of interest; and (3) the increased disclosure to the policyholder of costs and benefits under the contract. *Id.* In 1985, sales of universal life insurance accounted for almost 40% of life insurance purchases. See Life Insurance Factbook, note 30, at 13, 29.

⁶⁸ See Hahn & Adney, note 2, at 42-43. Although IRC § 101(f) clarified the status of flexible premium policies issued prior to 1984, the status of flexible premium contracts issued after 1983 remained unsettled. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 266(a), 96 Stat. 324, 547.

⁶⁹ See D. Manzier, R. Buechner & I. Goodfellow, *Why Universal Life 130* (1982) (discussing early universal life insurance policies that required, at most, a net amount at risk of \$10,000); 1983 Hearings, note 39, at 16, 29, 88-89, 156 (discussing increasing death benefit policies and other investment-oriented life insurance contracts).

⁷⁰ See 1983 House Report, note 4, at 102; 1984 Senate Report, note 4, at 523.

⁷¹ 1983 House Report, note 4, at 101-02; 1984 Senate Report, note 4, at 522-23.

⁷² 1983 House Report, note 4, at 101-02; 1984 Senate Report, note 4, at 522-23. The Treasury Department testimony on the taxation of life insurance reflected a similar ambivalence between retaining the historic tax treatment of life insurance while taxing comparable investments in the same manner. Although the Treasury Department supported the enactment of a more restrictive definition of life insurance, it did not advocate the current taxation of interest credited on life insurance policies. See 1983 Hearings, note 39, at 16, 37, 521-22 (testimony of Ass't Secretary Chapoton).

⁷³ IRC § 7702(b).

⁷⁴ IRC § 7702(c).

sent two paradigms of life insurance policy design.⁷⁵ If a policy is no more investment oriented than one of these models, it is treated as life insurance for tax purposes.⁷⁶ This line of demarcation is reflected in the statutory requirement that a life insurance contract must satisfy either the cash value accumulation test or the guideline premium limitation throughout the entire life of the contract.⁷⁷

Each paradigm employs actuarial limitations to maintain a balance between the amount of current insurance protection and the cash value of the contract. The use of complex actuarially based limitations⁷⁸ followed from the decision that all traditional level-premium cash value life insurance contracts would receive life insurance status.⁷⁹ To assure comparable treatment of policies issued to insured individuals of different ages and health, actuarial limitations were needed.

This initial decision to create actuarially based limitations gave rise to a serious concern that use of actuarial "gimmicks" and other tax-oriented strategies might enable excessively investment-oriented contracts to qualify as life insurance.⁸⁰ Section 7702, therefore, incorporates explicit, and complicated, safeguards to preclude the use of actuarial techniques designed to frustrate the statutory purpose.⁸¹

The primary economic difference between the two models of acceptable life insurance design involves the maximum cash value allowed for a given amount of current insurance protection at different stages of the life of a contract. Compared to the levels allowed under the guideline premium model, the "cash value accumulation" model permits relatively more cash value to accumulate during the initial years of the contract. In subsequent years, however, the magnitude of the cash value relative to the death benefit increases at a relatively slow rate.⁸² The guideline premium model, on the other hand, initially imposes tighter limits on the

⁷⁵ IRC § 7702(a). The "cash value accumulation" paradigm is a policy that has, at all times, a cash value equal to the net single premium described in § 7702(b)(1). The "guideline premium" model is a policy in which the premiums paid equal the guideline premium limitation at all times.

⁷⁶ IRC § 7702(a).

⁷⁷ 1983 House Report, note 4, at 145; 1984 Senate Report, note 4, at 572. Because the relative restrictiveness of the two models changes over the life of the contract, allowing compliance with the tests on a "pick and choose" basis would increase the permissible investment orientation.

⁷⁸ One commentator criticized the actuarial limitations as "beyond the comprehension of the average tax practitioner or revenue agent." Skillman, *The Impact of TEFRA and the 1984 Act on the "Inside Build-up" Under Life Insurance Products*, 43 N.Y.U. Inst. Fed. Tax'n 40-1, 40-24 (1985).

⁷⁹ 1983 House Report, note 4, at 146; 1984 Senate Report, note 4, at 573.

⁸⁰ See Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 651 (Comm. Print 1984) [hereinafter 1984 General Explanation].

⁸¹ See IRC § 7702(b)(2), (c)(3)(B), (4), (e), (f)(7). These limitations are discussed in Part II.

⁸² See notes 168-69 and the accompanying text.

maximum allowable cash value than exist under the cash value accumulation model but allows the cash value to increase more quickly.⁸³

Life insurance contracts that do not satisfy the detailed statutory requirements of § 7702 lose their tax preferred status. Section 7702 treats the cash value of a nonqualifying contract as a fully taxable investment fund.⁸⁴ Consequently, the policyholder includes in gross income the "income on the contract,"⁸⁵ which for any year, equals the sum of (1) the increase in the net surrender value⁸⁶ during the year and (2) the cost of insurance protection provided during the year, reduced by (3) the premiums paid during the year.⁸⁷ This approximates the amount of investment income credited under the policy.⁸⁸ Any amount paid due to the insured's death in excess of the cash value is treated as proceeds of a term life insurance policy and is therefore excluded from income.⁸⁹

2. Cash Value Accumulation Test

If a life insurance contract satisfies the cash value accumulation test, § 7702 treats it as a life insurance contract for tax purposes. A contract satisfies this test if, under the terms of the contract, the contract's cash

⁸³ Id.

⁸⁴ H.R. Rep. No. 861, 98th Cong., 2d Sess. 1074-76 (1984).

⁸⁵ IRC § 7702(g)(1)(A).

⁸⁶ IRC § 7702(f)(2)(B).

⁸⁷ IRC § 7702(g)(1)(B). If the contract previously satisfied the requirements of § 7702 but ceased to meet the requirements in the current taxable year, then the increase in cash value and the cost of term insurance for all prior years is treated as ordinary income in the current year as well. IRC § 7702(g)(1)(C). In the case of failed contracts, life insurance companies are subject to certain reporting and withholding requirements under § 3405. See 1983 House Report, note 4, at 149-50.

⁸⁸ Differences between the interest credited under the contract and the amount included in gross income may arise from two sources: First, for purposes of computing the income on the contract, the cost of insurance protection is the lesser of the mortality charges specified in the contract and the cost computed on the basis of uniform premiums prescribed by regulations. IRC § 7702(g)(1)(D). To the extent that the uniform premiums ignore factors that justify higher mortality charges for the particular insured individual, the income on the contract understates the interest credited. Second, expense charges imposed under the contract are allowed to offset the interest credited in computing the income on the contract. Understating the interest credited in this manner effectively allows the policyholder to deduct these otherwise nondeductible expenses against the interest credited to the contract's cash value. See notes 59-63 and the accompanying text.

⁸⁹ IRC §§ 101, 7702(g)(2). The amount payable upon the insured's death that represents the contract's cash value is not treated as paid under a life insurance contract. Although the exclusion from income under § 101 does not apply to this amount, the taxpayer's basis in the cash value should approximate its current value.

It is unclear whether the income on the contract for the year of the insured's death is includable in gross income. Section 7702(g)(2) treats as life insurance only the excess of the amount paid upon the insured's death over the net surrender value of the contract. Any increase in the net surrender value of the contract during the taxable year of the insured's death will not be excluded from income unless the net surrender value is computed as of the beginning of the taxable year.

value can never exceed the current "tax net single premium."⁹⁰ For any specified age of the insured, the net single premium is defined as the amount needed, in present value terms, to generate the cash values and pay the mortality charges for the death benefit specified in the contract.⁹¹ If a contract's cash value equals the tax net single premium, the policy contains a fund sufficient, when credited with interest at a specified rate, to pay for all future charges and obligations under the contract.⁹² The cash value accumulation test, therefore, denies life insurance status to contracts that, by their terms, permit accumulation of any additional cash value.

The traditional participating cash value life insurance contract, which specifies a fixed pattern of premium payments and a death benefit determinable based on the accumulated cash value, is the model for the cash value accumulation test.⁹³ The life insurance company computes premiums for such a policy on the assumptions that interest will be credited at assumed rates, and that certain additional charges will be imposed. In a participating policy, the insurance company may also pay policyholder dividends. Policyholder dividends may represent the crediting of interest at a rate in excess of the assumed rates. They may also represent reductions in the charges for either current insurance protection or administrative expenses below the levels reflected in the policy premium.⁹⁴ The

⁹⁰ IRC § 7702(b)(1). The term "net single premium" has a specific meaning under § 7702(b)(1) that differs from its usual actuarial definition. To reduce confusion, the term "tax net single premium" used herein refers to the net single premium computed in compliance with the requirements of § 7702.

Differences between the tax net single premium and the actuarial net single premium may arise from the use of statutorily mandated interest rate assumptions (see IRC § 7702(b)(2)(A)) or mortality assumptions (see IRC § 7702(c)(3)(B)(i)) that differ from the assumptions used in computing the actuarial net single premium. See notes 112-21 and the accompanying text. Moreover, the tax net single premium may reflect application of the computational rules contained in § 7702(e) that apply solely for purposes of § 7702.

⁹¹ See K. Black & H. Skipper, note 8, at 19. The net single premium changes as the insured ages. The cash value accumulation test looks at the entire life of the contract: The contract must not allow the cash value to exceed the net single premium for the current age of the insured. For purposes of § 7702 the actuarial assumptions used in computing the applicable net single premiums are fixed when the contract is issued. See notes 112-18 and the accompanying text.

⁹² K. Black & H. Skipper, note 8, at 19. If the actuarial assumptions used to compute the net single premium are flawed, the cash value may exceed or understate the amount required to fund the future benefits under the contract.

⁹³ 1983 House Report, note 4, at 146; 1984 Senate Report, note 4, at 573.

⁹⁴ K. Black & H. Skipper, note 8, at 151-53. The owner of a life insurance contract wears several hats vis-a-vis the insurance company: as a creditor, a customer, and, possibly an owner. To the extent that policyholder dividends consist of additional interest paid on indebtedness, they should be taxed in the same manner as other interest credited under the contract. See notes 171-227 and the accompanying text (discussing the justification for the current tax treatment of interest credited under life insurance contracts). Amounts representing premium rebates paid to the policyholder in the capacity as customer are properly excluded from income as an adjustment to the contract's purchase price. A third possibility reflects the position of

policyholder may elect to have the policyholder dividends used, as a single premium, to purchase additional amounts of insurance, or "paid-up additions."⁹⁵ Although the application of policyholder dividends to purchase paid-up additions increases both the contract's cash value and death benefit, under the traditional participating policy the cash value is constrained so that it never exceeds the net single premium for the increased death benefit.

a. Meaning and Significance of Assumed Interest Rates and Mortality Charges

To compute a net single premium, it is necessary to know: (1) the insured's age, (2) the benefits provided under the life insurance contract, (3) the charges imposed each year for current insurance protection; and (4) the rate at which interest is credited.⁹⁶ Ascertaining the insured's age and the contractual benefits generally is a simple factual matter.⁹⁷ The more difficult task is to determine the actual mortality charges and rate of interest. Frequently, these amounts are not absolutely fixed in the life insurance contract. Consequently, actuarial assumptions are made concerning the charges imposed for current insurance protection and the rate at which interest is credited.⁹⁸

For purposes of computing the tax net single premium, § 7702 limits the range of actuarial assumptions⁹⁹ to prevent the life insurance com-

the policyholders of a mutual company as its owners. To the extent that policyholder dividends constitute a distribution of corporate profits, it is arguable that they should be taxed in the same manner as dividends from other business entities. See 1984 General Explanation, note 80, at 612. Difficult questions are likely to arise if attempts are made to allocate policyholder dividends among these sources. Similar conceptual and measurement difficulties arise in connection with the characterization of policyholder dividends for purposes of computing the tax liability of mutual life insurance companies. See M. Graetz, *Life Insurance Company Taxation—the Mutual vs. Stock Differential* (1986).

⁹⁵ K. Black & H. Skipper, note 8, at 153. A policyholder can also elect to receive the policyholder dividend in the form of cash or certain cash equivalents. *Id.* Under principles of constructive receipt, the policyholder's right to receive a cash payment would be sufficient to justify taxing reinvested policyholder dividends.

⁹⁶ *Id.* at 331.

⁹⁷ Certain contractual benefits, however, are disregarded for purposes of § 7702. See IRC §§ 7702(e), (f)(4), (5); see also notes 255-312 and the accompanying text (discussing the treatment of additional benefits and the computational rules).

⁹⁸ K. Black & H. Skipper, note 8, at 331-35. The actuarial assumptions used depend on the purpose for which the net single premium is computed. For purposes of state regulation, the actuarial assumptions specified in the contract are generally used. Section 7702 may require use of different actuarial assumptions in computing the tax net single premium.

The tax net single premium computation disregards expense charges. See IRC § 7702(b)(2). Under a traditional single premium contract, the loading expenses charged are subtracted from the gross premium paid. Where no additional charges are imposed, the net single premium should not reflect any expense charges.

⁹⁹ See IRC § 7702(b)(2)(A), (c)(3)(B).

pany from inflating the tax net single premium and, correspondingly, the permissible investment orientation of the contract.¹⁰⁰ To illustrate the effect of different actuarial assumptions on the net single premium, consider a contract insuring the life of a 35-year-old individual for \$100,000. The net single premium for this contract is \$42,013 if it is assumed that interest is credited at a rate of 2½% and mortality charges are based on the 1958 Commissioners' Standard Ordinary (CSO) mortality table.¹⁰¹ The net single premium for the contract is reduced to \$13,951 if the assumed interest rate equals 6% and the 1980 CSO mortality table is used.¹⁰²

Although the assumptions chosen concerning interest rates and mortality charges greatly affect the size of net single premiums, these assumptions have less impact on the policyholder. As with the proverbial accounting records of a closely held business, three distinct interest rates (and schedules of charges) are maintained in connection with a life insurance contract. These are: (1) The assumed interest rate and schedule of charges used to determine the actuarial net single premium; (2) the contractually guaranteed rate and schedule of charges; and (3) the rates of interest actually credited and the charges actually imposed on the policyholder. Distinct functions are served by each interest rate and schedule of charges, with the third being of greatest significance to the policyholder.

The assumed interest rate and mortality charges are primarily used in computing the life insurance company's reserve liabilities to measure the company's solvency.¹⁰³ Except to the extent that they are also used in computing the tax net single premium, these amounts have no impact on policyholders.¹⁰⁴ Actuarial assumptions that increase the tax net single premium benefit a policyholder who is seeking the maximum degree of

¹⁰⁰ In the extreme case, a contract that assumes that no interest is credited would always have a net single premium equal to the death benefit under the contract. If the cash value of this contract were equal to the net single premium, no current insurance protection would be provided.

¹⁰¹ S. Huebner & K. Black, *Life Insurance* 356 (10th ed. 1982). The values contained in the 1958 CSO Table are based on the mortality experience of the early 1950's. In developing the CSO table, actual mortality rates are increased to provide a margin of safety for purposes of measuring the solvency of the life insurance company. K. Black & H. Skipper, note 8, at 313-20. Although the 1980 CSO mortality table is used increasingly, life insurance companies may continue to use the 1958 CSO mortality table until 1989, at which time use of the 1980 CSO table becomes mandatory. *Id.* at 319.

Clearly, these mortality tables fail to reflect societal and medical developments that have taken place in recent years. Although the contract's tax net single premiums are based on these tables, the life insurance company may base their premiums on more current mortality experience. *Id.* at 18, 319.

¹⁰² K. Black & H. Skipper, note 8, at 349.

¹⁰³ See *id.* at 346; see also IRC § 807.

¹⁰⁴ Section 7702 may mandate the use of different assumptions. See notes 112-24 and 150-61 and the accompanying text.

investment orientation. Under the cash value accumulation test, the cash value cannot exceed the tax net single premium.¹⁰⁵ Any increase in the tax net single premium allows a correspondingly larger cash value accumulation, and requires a smaller amount of current insurance protection as part of the package containing the tax preferred investment. The combined effect is that the policyholder's investment return, net of mortality charges, increases.¹⁰⁶ For this reason, an investment-oriented policyholder prefers that the contract assume a very low assumed interest rate and very high assumed mortality charges.

The contractually guaranteed interest rate and schedule of mortality charges serve an entirely different function.¹⁰⁷ Many life insurance contracts guarantee that the rate of interest credited will not fall below a specified rate and that the charges for current insurance protection will not exceed specified maximums. These guaranteed amounts frequently differ significantly from current market interest rates and mortality charges. Use of the nonmarket rate guarantees reflects concerns arising from the fact that a cash value life insurance contract may remain in effect for decades. The rate of interest guaranteed in the contract applies to both the current cash value and to the cash value attributable to future premium payments. The issuance of contracts that guarantee the crediting of interest at a very low rate protects the life insurance company from possible losses if market interest rates substantially decline. Similarly, the guaranteed level of mortality charges protects the life insurance company from adverse changes in the mortality experience of the population.¹⁰⁸

¹⁰⁵ See notes 90-92 and the accompanying text.

¹⁰⁶ To illustrate, consider two life insurance contracts using the actuarial assumptions specified in the examples in the text accompanying notes 101-02. Contract 1 insures the life of a 35-year-old individual for \$100,000. The net single premium for this contract is \$42,013 if the assumed interest rate is 2½% and the assumed mortality charges are those specified in the 1958 CSO mortality table. If these assumptions could be used in computing the tax net single premium (but see § 7702(b)(2), (c)(3)) the maximum cash value would equal \$42,013, and the minimum current insurance protection would equal \$57,987. Assuming that the policyholder paid a premium sufficient to generate the maximum cash value and that the actual mortality charges were based on the 1980 CSO mortality table, the actual first year mortality charges would be \$122.

Under Contract 2, the assumed interest rate equals 6% and the 1980 CSO mortality table is used. Because the net single premium for a contract with a \$100,000 death benefit is only \$13,951, a policyholder seeking the same initial cash value as under Contract 1 (\$42,013) must increase the death benefit to approximately \$300,000. The current insurance protection increases to approximately \$258,000, with actual mortality charges increasing to \$544. Consequently, the investment return, net of mortality charges, is reduced by \$422.

¹⁰⁷ Life insurance companies are not required to specify guaranteed interest rates and mortality charges. In the absence of explicit guarantees, minimum surrender values are computed in accordance with state nonforfeiture laws. K. Black & H. Skipper, note 8, at 358. Life insurance companies may provide guarantees more favorable to the policyholder than those required under the nonforfeiture laws to increase the sales appeal of their products.

¹⁰⁸ K. Black & H. Skipper, note 8, at 408-10.

The rate at which interest is credited and the actual charges for current insurance protection often differ significantly from both the actuarial assumed and the guaranteed rates.¹⁰⁹ Because they compete with other financial institutions that pay interest at market rates, life insurance companies have credited interest at rates more closely reflecting market conditions.¹¹⁰ Similar, albeit less intense, competitive pressures limit the charges for current insurance protection imposed under cash value life insurance policies. Term life insurance premiums, which tend to reflect current mortality experience,¹¹¹ act as a competitive force that limits the charges for current insurance protection under cash value life insurance policies.

b. Limits on Interest Rate and Mortality Assumptions Under the Cash Value Accumulation Test

As discussed above, the tax net single premium for a life insurance contract is computed using assumptions about interest rates and mortality charges.¹¹² Because the maximum cash value allowed under the cash value accumulation test equals the tax net single premium, the choice of the interest rate used in making this computation assumes great importance. To maintain a meaningful balance between investment and current insurance protection, § 7702 prohibits the use of unduly low interest rates in computing the tax net single premium. For contracts subject to the cash value accumulation test, the minimum rate of interest is 4%,¹¹³

¹⁰⁹ See *id.* at 71, 77-79, 85-88.

¹¹⁰ See 51 Consumer Reports 448-50 (1986) (stating that the rate of return on cash value life insurance increased markedly between 1980 and 1986, reflecting high market rates of interest); see also K. Black & H. Skipper, note 8, at 96. Different mechanisms are used to credit interest at rates in excess of the assumed rate. Traditionally, life insurance companies marketed two types of policies: participating and nonparticipating. Under a traditional participating policy, the policyholder receives an annual policyholder dividend. This dividend reflects, in part, the interest that the life insurance company earned with the policyholder's funds. See note 94. In a traditional nonparticipating life insurance policy, interest is credited at the rate guaranteed in the contract. K. Black & H. Skipper, note 8, at 27. For this reason, the stated rate of interest is of greatest significance in this type of policy.

In recent years, the differences between participating and nonparticipating policies have become less distinct. Although technically nonparticipating, most universal life insurance policies credit interest at rates in excess of the assumed rate explicitly, rather than as a component of a policyholder dividend. *Id.* at 28. Similarly, the cash value of a variable life insurance policy is determined by reference to the value of shares in an underlying mutual fund. The value of these shares reflects the fund's investment income. *Id.* at 68-69. Other contemporary nonparticipating policy designs credit interest at rates that more closely reflect market conditions.

¹¹¹ See K. Black & H. Skipper, note 8, at 54-55.

¹¹² See notes 96-102 and the accompanying text.

¹¹³ IRC 7702(b)(2)(A). For life insurance contracts that require at least 20 nondecreasing annual payments issued pursuant to a plan of insurance filed prior to September 28, 1983, the tax net single premium may be computed using a 3% interest rate. IRC § 7702(i). Because

unless higher rates are guaranteed at the time the contract is issued.¹¹⁴

The choice of mortality charges used in computing the tax net single premium may have a similar effect on the maximum permissible cash values. In general, an increase in the assumed mortality charges produces a larger tax net single premium.¹¹⁵ Prior to the enactment of the 1988 Technical Corrections Act, § 7702 did not expressly limit the maximum permissible mortality charges.¹¹⁶ The mortality charges used in computing the tax net single premium were those specified in the contract or, if none were specified, those used in determining statutory reserves for the contract.¹¹⁷ The 1988 Technical Corrections Act specifies that only "reasonable" mortality charges are taken into account in making these calculations.¹¹⁸

The framers of § 7702 anticipated that market forces would discourage life insurance companies from specifying excessive mortality charges in life insurance contracts.¹¹⁹ Unfortunately, it is doubtful that market forces provide adequate safeguards. First, consumers are unlikely, or unable, to compare the relative mortality charges specified in different life insurance contracts.¹²⁰ Second, the mortality charges used in computing the tax net single premium are the contractually specified maximums. To

few plans of insurance filed before 1984 incorporated the 1980 CSO mortality table, this transition rule will become moot due to the requirement that plans of insurance incorporate the 1980 CSO mortality table by 1989. K. Black & H. Skipper, note 8, at 360.

¹¹⁴ IRC § 7702(b)(2)(A). If the guaranteed interest rate exceeds 4%, the tax net single premium is computed using the higher rate with respect to the period during which the guarantee applies. Higher interest rates are typically guaranteed only for the first year that the policy is in effect. One commentator suggested that regulations should allow life insurance companies to disregard guarantees lasting only one policy year. See Hahn & Adney, note 2, at 44. The Joint Committee on Taxation indicated, however, that life insurance companies cannot disregard short-term guarantees in computing the tax net single premium and the guideline single premium. 1984 General Explanation, note 80, at 649. These short-term guarantees can be disregarded in computing the guideline level premiums. *Id.*

The only guaranteed rates of interest reflected in the tax net single premium are those rates guaranteed when the contract is issued. Subsequent interest rate guarantees are disregarded even if the guarantees result from the application of contractual provisions indexing the interest rates to changes in specified market rates. *Id.* at 648.

¹¹⁵ See K. Black & H. Skipper, note 8, at 349 (Table 20-1). The effect of increased mortality on other computations, such as the net level premium, is less clear. *Id.* at 349-50.

¹¹⁶ See IRC § 7702(b)(2)(B), (c)(3)(B)(i), amended by 1988 Technical Corrections Act § 5011.

¹¹⁷ *Id.*

¹¹⁸ Section 7702(c)(3)(B)(i) further provides that, unless permitted by regulation, the charges cannot exceed the mortality charges specified in the prevailing commissioners' standard table applicable when the contract is issued. Until regulations are issued under this provision, however, life insurance companies may use mortality charges "which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristics of the insured of which the company is aware)" 1988 Technical Corrections Act § 5011(c)(2).

¹¹⁹ See Hahn & Adney, note 2, at 53 n.56.

¹²⁰ See Consumer Reports, note 110, at 450-54 (discussing the practical difficulties involved in obtaining information necessary to compare the costs of different life insurance contracts).

the extent that consumers compare costs, they need to focus on the actual charges, rather than these theoretical maximums.¹²¹

Because market forces did not limit the stated mortality charges, the absence of explicit statutory limits created the possibility that investment-oriented life insurance contracts would specify extremely high mortality charges.¹²² For contracts issued prior to the effective date of the changes contained in the 1988 Technical Corrections Act,¹²³ use of excessive mortality charges for purposes of computing the tax net single premium is subject to challenge on several grounds. First, if the high charges were not bona fide, the tax net single premium should reflect the bona fide charges. For example, if the company assured the policyholders, either formally or informally, that the actual mortality charges would be lower, then the lower amounts are the charges specified in the contract.¹²⁴ Similarly, lower mortality charges are implicitly stated in the contract if guaranteed cash values reflect lower charges than are stated in the contract.¹²⁵ These lower rates are the charges taken into account in computing the tax net single premium.

For contracts entered into on or after October 21, 1988, use of unreasonable mortality charges in computing the tax net single premium or the guideline premiums is expressly prohibited.¹²⁶ The legislative history anticipates that regulations will set forth standards for determining the rea-

¹²¹ *Id.*

¹²² A recent study revealed that 20% of single premium life insurance contracts specified mortality charges that were at least twice as large as the mortality charges included in the applicable commissioners' standard ordinary table. U.S. General Accounting Office, *Tax Policy Mortality Charges on Single Premium Life Insurance Should Be Restricted* (1988). This study also illustrates how the specification of higher mortality charges increases the tax net single premium and the guideline single premiums. *Id.* at 5.

In the mathematically extreme case, the annual mortality charges would equal the product of the assumed rate of interest multiplied by the cash value as of the beginning of the year. The actuarial net single premium for this contract would equal the initial death benefit specified under the contract. To illustrate, assume that the contract specifies a \$100,000 death benefit and cash values at all times equal \$95,000. The annual mortality charge is the product of the assumed rate of interest (4%) multiplied by the initial cash value (\$95,000), or \$3,800. Because the interest earned on the initial cash value at the assumed rate of 4% precisely offsets the mortality charges, the cash value will never increase. The actuarial net single premium for this contract is the amount needed, in present value terms, to generate the cash values and pay the mortality charges for the death benefit specified in the contract. Consequently, the net single premium will exceed \$95,000. For a more rigorous mathematical exposition on the computation of net single premiums, see K. Black & H. Skipper, note 8, at 331-36.

¹²³ Section 7702(c)(3)(B)(i) specifies that only reasonable mortality charges are taken into account in computing the tax net single premium and the guideline premiums, and applies to contracts entered into on or after October 21, 1988. 1988 Technical Corrections Act § 5011(d).

¹²⁴ See 1984 General Explanation, note 80, at 648-49.

¹²⁵ *Id.* at 649.

¹²⁶ IRC § 7702(c)(3)(B)(i). In addition, the mortality charges generally cannot exceed the charges specified in the applicable prevailing commissioners' standard table. *Id.* Until regulations are issued under § 7702(c)(3)(B)(i), however, mortality charges that do not differ materi-

sonableness of mortality charges with respect to substandard risks.¹²⁷ In drafting these regulations, the Treasury Department should only permit the use of mortality charges in excess of those specified in the applicable commissioners' standard table in unusual circumstances. Because these tables reflect the mortality of the entire population increased to provide a "mortality cushion,"¹²⁸ the mortality experience of a life insurance company with respect to its policyholders is likely to be no worse than the implicit mortality experience reflected in this table.¹²⁹ Even in those circumstances where there exists a bona fide underwriting basis for higher mortality charges, the regulations should further require the company to demonstrate that the mortality charges were not excessive in light of current mortality experience with comparable groups of substandard insureds.

3. *Guideline Premium/Cash Value Corridor Test*

The second alternative test that a contract may satisfy to qualify as life insurance for tax purposes is the guideline premium/cash value corridor test,¹³⁰ which imposes two requirements: First, the cumulative dollar amount of premiums actually paid under the contract can never exceed the guideline premium limitation.¹³¹ Second, the ratio of the death benefit to the cash value of the policy cannot, at any time, fall below specified percentages.¹³² The minimum amount of current insurance protection for a given death benefit constitutes the cash value corridor.

As discussed above, the cash value accumulation test and the guideline premium limitation test reflect different conceptual models of life insurance.¹³³ The cash value accumulation test mimics a traditional participating cash value policy under which interest credited in excess of the guaranteed rates purchases paid-up additions.¹³⁴ In comparison, the guideline premium test reflects the distinguishing characteristics of the universal life insurance policy design.¹³⁵ Before examining the differ-

ally from the amounts that the company expects to charge can be used. 1988 Technical Corrections Act § 5011(c)(2).

¹²⁷ H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 108 (1988).

¹²⁸ K. Black & H. Skipper, note 8, at 317.

¹²⁹ See Sternhill & Shur, *Probability, Mortality and Money Concepts, Life and Health Insurance Handbook* 121, 128-30 (D. Gregg & V. Lucas eds. 1973).

¹³⁰ IRC § 7702(a)(2).

¹³¹ IRC § 7702(a)(2)(A), (c).

¹³² IRC § 7702(a)(2)(B), (d).

¹³³ See notes 73-77 and the accompanying text.

¹³⁴ See notes 93-95 and the accompanying text.

¹³⁵ See Hahn & Adney, note 2, at 43. Certain nontraditional features of universal life insurance appear in other life insurance products. See K. Black & H. Skipper, note 8, at 68-74, 81-82. The textual emphasis on the universal life insurance policy design reflects its large and growing share of life insurance product sales. Although not marketed until 1979, sales of

ences between the two tests, it is helpful to understand the differences between the traditional and the universal models of life insurance.

Universal life insurance was developed in the late 1970's to overcome several shortcomings of traditional cash value life insurance that reduced its marketability.¹³⁶ First, traditional cash value contracts are rigid in structure. Under these contracts, a purchaser pays a specified premium at predetermined intervals. In addition, the policyholder cannot change the contract's death benefit after the contract is issued. Second, the economic relationships implicit in the contract were incomprehensible to most consumers. Although the insurance company credits interest and imposes charges for the current insurance protection provided,¹³⁷ these amounts were not disclosed to the policyholder. Third, during the late 1970's and early 1980's, the rate of interest credited was low in comparison to the rates available from competing investments.¹³⁸

Universal life insurance was designed to overcome each of these shortcomings.¹³⁹ First, it allows a far greater degree of flexibility than is permitted under traditional cash value contracts. Initially, a universal life policyholder determines the size of the initial premium and the initial death benefit. The timing and size of subsequent premium payments are within the complete discretion of the policyholder. In addition, the insured may increase or decrease the death benefit as the need for insurance changes. Second, universal life discloses the economic relationships, interest rates, and charges that are implicit in traditional contract designs: Premium payments are added to the contract's cash value which, in turn, is reduced by charges for current insurance protection. The remaining cash value earns interest. Insurance protection continues until the cash value is depleted. A universal life policyholder receives periodic statements summarizing these developments. Third, interest rates and charges for current insurance protection under universal life contracts are more likely to reflect current market conditions.¹⁴⁰

For purposes of understanding the guideline premium limitation, increased policyholder flexibility is the most significant feature of the universal life insurance policy design. The policyholder can decide both

universal life insurance accounted for almost 40% of life insurance sales in 1985. Life Insurance Factbook, note 30, at 13, 27-28.

¹³⁶ See Comment, TEFRA's Conversion of Universal Life Insurance Into the Flexible Premium Life Insurance Contract, note 31; Comment, Federal Taxation of Life Insurance Products After the Tax Reform Act of 1984, note 31, at 245-48.

¹³⁷ See notes 32-46 and the accompanying text.

¹³⁸ See Comment, TEFRA's Conversion of Universal Life Insurance Into the Flexible Premium Life Insurance Contract, note 31, at 327.

¹³⁹ See K. Black & H. Skipper, note 8, at 83-99 (discussing the origins and design of universal life insurance).

¹⁴⁰ *Id.* at 91-93; Comment, TEFRA's Conversion of Universal Life Insurance Into the Flexible Premium Life Insurance Contract, note 31, at 328-30.

when to pay a premium and how much to pay.¹⁴¹ The guideline premium test provides the flexibility purportedly needed to accommodate the universal life insurance policy design.¹⁴²

a. Guideline Premium Limitation

Under the guideline premium limitation, the cumulative premiums paid under a life insurance contract cannot exceed the "guideline premium limitation,"¹⁴³ which is intended to roughly approximate the cumulative amount of premiums payable under a policy subject to the cash value accumulation test. Although the cash value accumulation test does not explicitly limit the premiums paid, it does so implicitly by barring premiums that would cause the cash value to exceed the current tax net single premium. The premium payment schedule is immaterial. Consequently, the policyholder can pay a single premium or level annual premiums.¹⁴⁴ A flexible premium schedule results automatically from the use of the net single premium as the limitation in the cash value accumulation test.

The guideline premium limitation incorporates a similar degree of flexibility through its express limitations on premiums paid. No fixed premium limitation would allow policyholders the choice of paying either a single premium sufficient to fund the benefits under the contract or a series of premium payments that approximates the less rapid pace of the level premium contract.¹⁴⁵ Section 7702 accommodates both premium

¹⁴¹ See note 67; see also S. Rep. No. 494, 97th Cong., 2d Sess. 352 (1982). Most universal life insurance contracts also allow the policyholder to increase the death benefit provided without purchasing a new contract. Limitations on the amount of the increase generally apply unless evidence of the insured's insurability is demonstrated. K. Black & H. Skipper, note 8, at 88.

¹⁴² See Hahn & Adney, note 2, at 43; Skillman, note 78, at 40-17.

¹⁴³ IRC § 7702(c)(1). In determining compliance with the guideline program limitation, a premium payment that otherwise would cause the contract to fail the guideline premium limitation is disregarded if the premium payment is returned by the insurance company to the policyholder within 60 days following the end of the contract year. IRC § 7702(f)(1)(B). Because § 7702 allows the refund of excessive premiums after the close of the contract year, precise actuarial computations are required only at the end of each contract year.

To prevent this rule of administrative convenience from increasing the possible investment orientation of a contract, the life insurance company is required to pay interest on the amount refunded. IRC § 7702(f)(1)(B). Because the required payment of interest on the excessive premiums is included in the policyholder's income (IRC § 7702(f)(1)(C)), it is treated in a manner similar to other taxable forms of interest.

¹⁴⁴ See notes 32-45 and the accompanying text (discussing the components of a level premium and a single premium life insurance contract). Under the contracts illustrated therein, the policyholder may pay either a single premium of \$25,188 or level annual premiums of \$1,279. As long as the cash value cannot exceed the tax net single premium, any other premium payment schedule can be used.

¹⁴⁵ To accommodate the single premium, a fixed premium limitation must be at least as large as the single premium. Use of a fixed premium limitation equal to the single premium,

payment schedules by defining the guideline premium limitation as the greater of the guideline single premium and the sum of the guideline level premiums.¹⁴⁶ The guideline single premium is the amount needed to pay for the future benefits provided under the contract if only a single premium is paid.¹⁴⁷ The guideline level premium represents the annual premium needed if premiums are paid each year until the insured reaches 95 years of age.¹⁴⁸ The sum of the guideline level premiums equals the guideline level premium multiplied by the number of years that the contract has been in effect.¹⁴⁹

The guideline single premium and the guideline level premium are computed using actuarial principles. These guideline premiums estimate the amounts needed to generate the cash value and to pay the mortality and expense charges imposed under the life insurance contract. The statute restricts the choice of actuarial assumptions used in computing the guideline premiums to ensure that they do not frustrate the goal of the limitation.¹⁵⁰

The first actuarial limitation establishes the minimum rate at which interest is assumed to be credited under the contract. As discussed above, a lower assumed interest rate increases the amount needed upon issuance to pay for the benefits provided under the contract.¹⁵¹ For the investment-oriented policyholder, permitting the payment of larger premiums allows more cash value to be accumulated. Because the larger cash value is both credited with additional interest and reduces the

however, will not accommodate the level annual premium payment schedule. Although the premium for a single premium policy always exceeds the level annual premium for a policy with otherwise identical terms, the cumulative amount paid as level premiums ultimately exceeds the single premium. For example, under the policies illustrated in Appendix Tables I and II, the single premium of \$25,188 is far in excess of the annual premium of \$1,279. If the premium limitation were to equal the single premium of \$25,188, payment of 20 annual premiums would violate the limitation because the cumulative premiums paid would total \$25,580.

The need for the additional premiums under the level premium contract is attributable to two factors: First, in each year, more interest is credited under the single premium contract because of its greater cash values. Second, in each year, the single premium contract's mortality charges are less because of its smaller current insurance protection. Ultimately, additional premiums are needed under the level premium contract both to pay the higher mortality charges and to compensate for the lesser amount of interest earned.

¹⁴⁶ IRC § 7702(c)(2).

¹⁴⁷ IRC § 7702(c)(3)(A). Because the guideline premium limitation restricts the gross premiums payable by the policyholder, expense charges specified in the contract are reflected in the guideline premium computations. IRC § 7702(c)(3)(B)(ii).

¹⁴⁸ IRC § 7702(c)(4).

¹⁴⁹ See Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, 94th Cong., 2d Sess., at 371-73 (Comm. Print 1982) [hereinafter 1982 General Explanation].

¹⁵⁰ IRC § 7702(c)(3), (4). Similar restrictions apply to the computation of the tax net single premium. See IRC § 7702 (b)(2); notes 112-18 and the accompanying text.

¹⁵¹ See notes 99-102 and the accompanying text (discussing the significance of the assumed rate of interest).

amount of current insurance protection, the final result is a more investment-oriented contract.

The interest rate assumed in computing the guideline single premium is the greater of 6% or the rate (or rates) guaranteed at the time that the contract is issued.¹⁵² This assumed rate of interest is significantly higher than the 4% rate used in computing the tax net single premium under the cash value accumulation test.¹⁵³ Because of the higher assumed rate of interest, the guideline single premium is usually smaller than the tax net single premium.¹⁵⁴ As a result, the maximum cash values generated during the initial years¹⁵⁵ of otherwise identical policies are generally lower for contracts tested under the guideline premium test than they are under the cash value accumulation test.¹⁵⁶

The rate of interest used in computing the guideline level premium is 4%, rather than the 6% rate used in computing the guideline single premium.¹⁵⁷ Because identical interest rates are used in computing the guideline level premium and the tax net single premium, the same premiums could be charged under otherwise identical level-premium policies regardless of the test used to determine compliance with § 7702. These otherwise identical policies also produce the same cash value during the initial years of the policies.

Additional actuarial assumptions concerning mortality and expense charges are reflected in both the guideline single premium and the guide-

¹⁵² IRC § 7702(c)(3)(iii); see note 114 (discussing the meaning of interest rates guaranteed upon the issuance of the contract).

¹⁵³ IRC § 7702(b)(2)(A). Any higher rate (or rates) of interest guaranteed upon issuance of the contract is also used in computing the tax net single premium. *Id.*; see also note 114.

¹⁵⁴ Expense charges imposed under a contract are reflected in the guideline single premium (see IRC § 7702(c)(3)(B)(ii)) but not in the tax net single premium (see IRC § 7702(b)(2)). Where expense charges are substantial, the guideline single premium could exceed the tax net single premium for the same contract.

¹⁵⁵ Use of the term "initial years" is intentionally imprecise. The actual time period depends on several factors, including the age of the insured when the contract is issued and the rates at which interest is actually credited. For example, higher interest rates shorten the period during which cash values are more restricted under the guideline premium limitation.

¹⁵⁶ There are two possible explanations for the higher assumed interest rate used to compute the guideline single premium. First, the more restrictive limitation resulting from the 6% interest rate assumption may be offset by the less restrictive cash value corridor. See notes 162-68 and the accompanying text. Comparable restrictions on investment orientation under the cash value accumulation test and guideline premium/cash value corridor test can be achieved without using identical assumed interest rates.

Second, it is arguable that the 6% rate is a more reasonable estimate of the market interest rates anticipated over the life of a contract. Many existing plans of insurance, including many that are less investment oriented than a single premium contract using the 6% assumption, would not have satisfied the requirements of § 7702 if a 6% rate had been used for all purposes. In light of the decision to treat traditional level-premium contracts as life insurance under § 7702, use of a lower interest rate was required.

¹⁵⁷ IRC § 7702(c)(4).

line level premium.¹⁵⁸ Because of the possibility that inflated charges may artificially increase a contract's investment orientation,¹⁵⁹ the guideline premiums are based on reasonable mortality and expense charges.¹⁶⁰ The anticipated regulations concerning the reasonableness of mortality charges, discussed in connection with the cash value accumulation test, are equally applicable to the guideline premium limitation.¹⁶¹

b. Cash Value Corridor

The second requirement of the guideline premium/cash value corridor test is that the contract fall within the cash value corridor.¹⁶² This requirement operates as a backstop to the guideline premium: It requires that a contract always maintain a minimal balance between current insurance protection and cash value.¹⁶³ For example, consider a contract insuring the life of a 35-year-old. As long as the insured is not older than 40 years of age, the cash value corridor requires that the life insurance contract provide a death benefit of at least 250% of the contract's current cash value.¹⁶⁴ Thus, if the contract's current cash value equals \$10,000, the death benefit at that time cannot be less than \$25,000. As the insured ages, the minimum death benefit for a given cash value declines:¹⁶⁵ At age 50, the the minimum death benefit is only 185% of the contract's current cash value.¹⁶⁶

A requirement analogous to the cash value corridor is implicit in the cash value accumulation test. There, however, the relative size of the

¹⁵⁸ IRC § 7702(c)(3)(B)(i), (ii).

¹⁵⁹ See notes 100-02 and the accompanying text.

¹⁶⁰ IRC § 7702(c)(3)(B)(i), (ii). See also notes 126-29 and the accompanying text. Even if the expense charges are reasonable, they can only be taken into account in computing the guideline premiums if, based on the company's experience with similar contracts, they are "reasonably expected to be actually paid." IRC § 7702(c)(3)(B)(ii).

¹⁶¹ See notes 126-29 and the accompanying text.

¹⁶² IRC § 7702(a)(2)(B).

¹⁶³ 1983 House Report, note 4, at 147 (1983); 1984 Senate Report, note 4, at 574; see also Chiechi & Adney, *An Analysis of the Effects of the Life Insurance and Annuity Provisions of TEFRA*, 57 J. Tax'n 338, 341 (1982).

Even where a contract complies with the guideline premium limitation, its cash value may grow too large relative to the death benefit provided under the contract for various reasons. First, the actual experience under the contract may differ substantially from what was assumed in computing the guideline premiums. For example, the rate of interest actually credited may exceed the 4 or 6% rate reflected in the guideline premium computation. Similarly, the actual charges for mortality and expenses may be less than the amounts specified in the contract.

Second, the guideline premiums will reflect certain charges for "qualified additional benefits." See IRC § 7702(f)(5)(B); notes 255-66 and the accompanying text. The resulting increase in the guideline premiums may permit the cash value to increase to levels deemed inappropriate. Qualified additional benefits are disregarded under the cash value corridor.

¹⁶⁴ IRC § 7702(d).

¹⁶⁵ IRC § 7702(d)(2).

¹⁶⁶ *Id.*

death benefit and cash value is determined as a byproduct of the net single premium concept. The cash value corridor, in contrast, explicitly specifies fixed ratios that policies must maintain for policyholders of different ages.¹⁶⁷ In general, these ratios are less than the ratios that result from the application of the tax net single premium requirement of the cash value accumulation test.¹⁶⁸ Consequently, under the guideline premium test, the cash value is generally permitted to increase to a larger percentage of the current death benefit than is permitted under the cash value accumulation test.

It is not possible to determine on a generalized basis whether the cash value accumulation test or the guideline premium test permits a greater degree of investment orientation.¹⁶⁹ In part, this comparison depends on the interplay of numerous factors, including the age of the insured at the time that the contract is issued and the rates of interest actually credited to the policyholder. To the extent that the rates of interest actually credited exceed 6%, the smaller single premium permitted under the guideline premium test will have less impact on the ultimate investment return to the policyholder. In these circumstances, the smaller amount of current insurance protection required to satisfy the cash value corridor may result in a contract that produces a greater investment return than would be produced under the cash value accumulation test. If interest rates are more modest, however, the higher single premium permitted for contracts subject to the cash value accumulation test is likely to produce a higher rate of return than the most dues investment-oriented policy that is subject to the guideline premium test.

D. Tax Policy Analysis of Policyholder Tax Treatment and Section 7702's General Limitations

The preferential tax treatment traditionally accorded income credited under a cash value life insurance contract was not substantially altered in either the Tax Reform Act of 1984 or the Tax Reform Act of 1986. Section 7702 only denies these tax benefits to certain contracts that are overly investment oriented.¹⁷⁰ In evaluating whether the existing tax treatment of investments made in the form of cash value life insurance is

¹⁶⁷ *Id.*

¹⁶⁸ See DesRochers, *The Definition of Life Insurance Under Section 7702 of the Internal Revenue Code 65-66* (unpublished manuscript); Skillman, note 78, at 40-19 through 40-20. The presence of "qualified additional benefits" in a contract increases the contract's tax net single premium. See 1983 House Report, note 4, at 146-47; 1984 Senate Report, note 4, at 574. If the charges for the qualified additional benefits are sufficiently large, the cash value accumulation test will allow lower death benefit/cash value ratios than are permitted under the cash value corridor.

¹⁶⁹ See 1983 House Hearings, note 39, at 573-74 (statement of Hartzel Z. Lebed).

¹⁷⁰ See notes 71-72 and the accompanying text.

justified, the following tax policy questions are considered. First, does justification exist for the current tax treatment of interest credited under cash value life insurance? Second, does § 7702 establish appropriate limits on the range of life insurance contracts that qualify for the preferential tax treatment?

1. An Evaluation of the Current Tax Treatment of Interest Credited Under Cash Value Life Insurance

It is impossible to reconcile the tax treatment of investments made in the form of cash value life insurance with the treatment of other financial investments. The interest or other investment income¹⁷¹ credited to life insurance contracts is not taxed until (and unless) cash or other property is distributed to the policyholder prior to the death of the insured.¹⁷² For this purpose, a loan from the life insurance company secured by a contract's cash value generally is not treated as a distribution.¹⁷³ Moreover, no limitations are imposed on the amount that a policyholder can invest in a life insurance contract.¹⁷⁴

Interest income generally is included in income currently.¹⁷⁵ The most significant exceptions to this general rule involve interest on state and local bonds¹⁷⁶ and interest income credited to qualified pension plans,

¹⁷¹ The same tax treatment applies to owners of both variable life insurance contracts and nonvariable life insurance contracts. See 1983 House Report, note 4, at 145; 1984 Senate Report, note 4, at 572. In effect, the owner of a variable life insurance contract invests the contract's cash value in assets such as money market funds, bond funds, common stock funds, or real estate funds. K. Black & H. Skipper, note 8, at 68.

One tax benefit is available solely to owners of variable life insurance contracts. Section 1035 states that no gain is recognized if a taxpayer exchanges one life insurance contract for a second life insurance contract. To the extent that indirect investments are made in stocks or bonds through the purchase of a variable life insurance contract, the policyholder is able to exchange investments without recognizing gain. Cf. Rev. Rul. 82-54, 1982-1 C.B. 11. An exchange of stocks, bonds, or notes owned directly by the policyholder, however, does not qualify as a like-kind exchange. Consequently, the owner of these types of assets recognizes gain upon an exchange. IRC § 1031(a)(2)(C).

¹⁷² See notes 49-51 and the accompanying text.

¹⁷³ See notes 53, 56 and the accompanying text.

¹⁷⁴ See IRC §§ 219(b), 415.

¹⁷⁵ IRC § 61(a)(4). Interest income is not limited to amounts actually received by a taxpayer. Amounts that substitute for interest payments, such as the accrual of original issue discount, are treated as interest income according to the principles of economic accrual. See IRC §§ 483, 1271-1275. From an economic perspective, market discount is indistinguishable from original issue discount. 1984 Senate Report, note 4, at 255. Amortization of market discount, however, is not treated as interest income under the provisions applicable to original issue discount. *Id.* Congress determined that the administrative complications that would be produced by subjecting market discount to those provisions outweighed the recognized theoretical correctness of doing so. *Id.*

¹⁷⁶ See IRC § 103. Interest paid on tax-exempt private activity bonds issued after August 7, 1986 is an item of tax preference (IRC § 57(a)(5)), but interest credited under a cash value life

individual retirement accounts (IRAs), and deferred annuities.¹⁷⁷ Although qualified pension plans and IRAs receive extremely favorable treatment under the Code,¹⁷⁸ restrictions limit the amount that an individual can invest in these tax favored savings vehicles.¹⁷⁹ In addition, loans from pension plans, individual retirement accounts, or annuities (or loans secured by these assets) are generally treated as taxable distributions and result in the immediate taxation of tax deferred amounts.¹⁸⁰

Many commentators question the justification for treating interest credited under a life insurance contract differently from other forms of income from savings.¹⁸¹ Several arguments have been advanced, however, in defense of this favorable treatment. These arguments are discussed and evaluated below.

a. Would Current Taxation of Interest Credited Under a Life Insurance Contract Constitute a Tax on Unrealized Appreciation?

The first argument raised in support of the existing tax treatment of life insurance is that an increase in the cash value of a life insurance contract represents unrealized appreciation: "taxing a policyholder currently on the increase in the cash value of a life insurance policy would be like taxing a homeowner each year on the appreciation in value of the home even though the home has not been sold."¹⁸² Consequently, it is

insurance contract is not. For taxpayers subject to the alternative minimum tax, life insurance contracts are taxed more favorably than tax-exempt private activity bonds.

¹⁷⁷ For purposes of this article, the term "deferred annuities" is limited to arrangements not part of a qualified pension plan.

¹⁷⁸ See IRC §§ 402(a), 408(d)-(e), 501(a); Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 Tax L. Rev. 433, 445-46 (1987). In addition to deferring the taxation of interest credited under a pension plan, an employee excludes from income the employer contribution to a pension plan. The net economic effect of these two consequences may be more favorable than taxing the amount contributed on the employee's behalf and then exempting from taxation the investment income earned.

¹⁷⁹ See IRC § 219(b) (providing limitations on the maximum deduction allowed for contributions to an Individual Retirement Account); IRC § 415 (providing limitations on benefits and contributions under qualified plans). To obtain qualified pension plan status, additional requirements relating to coverage, vestings, and benefits must be satisfied. See Altman, note 178, at 456-500.

¹⁸⁰ IRC § 72(e)(4)(A), (p). A loan under (or secured by) a modified endowment contract is also treated as a taxable distribution. IRC § 72(e)(10).

¹⁸¹ See Brannon, *Taxation of Inside Buildup on Life Insurance Policies—Interim Report or Post-mortem*, 32 Tax Notes 735 (1986); Goode, note 27, at 45-52; Irenas, note 27, at 312-17; McLure, note 34, at 392-95; Vickery, note 2, at 560-63; Paul, note 2, at 210, 222. Cf. Graetz, *The Troubled Marriage of Retirement Security and Tax Policy*, 135 U. Pa. L. Rev. 851, 902-04 (1987).

¹⁸² Tax Reform Proposals-XXII, Hearings Before The Senate Committee on Finance, 99th Cong., 1st Sess. 394 (1985) (statement of the American Council of Life Insurance) [hereinafter 1985 Senate Hearings].

argued, the interest credited should not be subject to tax until the gain is realized.¹⁸³

There are two possible responses to this argument. First, Professor Shakow has suggested that the taxation of unrealized appreciation would improve the efficiency, equity, and simplicity of the income tax.¹⁸⁴ Under this accrual system of taxation, interest credited under cash value life insurance contracts would be taxed currently.¹⁸⁵ It is not clear, however, that the taxation of unrealized appreciation on a piecemeal basis is equally beneficial.

Even assuming retention of the general realization requirement, it is questionable whether an increase in a life insurance contract's cash value represents the type of appreciation taxed only upon realization. Treating an increase in cash value as unrealized appreciation ignores the distinction between changes in the value of an asset caused by market forces, which are not taxed until realized through disposition, and those reflecting current compensation for the use of the asset which are currently realized and taxed in accordance with the taxpayer's method of accounting. In many situations, property owners are taxed on investment income that is not received. Partners in a partnership and shareholders of S corporations are taxed currently on their shares of income earned and retained by the business entity.¹⁸⁶ Interest accruing on debt instruments having original issue discount, including a certificate of deposit issued by a bank, is included in income despite the absence of a sale of the instrument.¹⁸⁷

In each of these examples, the property values reflect income earned but not received by property owners. Current taxation of the property

¹⁸³ See 1985 Senate Hearings, note 182, at 272-76 (statement of W.H. Cox); *id.* at 392-97 (statement of the American Council on Life Insurance); Schweiker, note 34; see also Brannon, note 181, at 736; Irenas, note 27, at 314-17; McLure, note 34, at 394-95.

Questions have been raised concerning the constitutionality of current taxation of unrealized gain. See Brannon, note 181, at 736; Rapp, *Some Recent Developments in the Concept of Taxable Income*, 11 *Tax L. Rev.* 329, 340 (1955). The consensus among commentators, however, is that taxation of unrealized gains would withstand a constitutional challenge. M. Graetz, *Federal Income Taxation* 177 (1985); W. Andrews, *Basic Federal Income Taxation* 124 (1985); Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 *Ill. L. Rev.* 779 (1941), excerpted in Surrey, McDaniel, Ault & Koppelman, *Federal Income Taxation* 120 (1986).

¹⁸⁴ See Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 *U. Pa. L. Rev.* 1111, 1114 (1986).

¹⁸⁵ *Id.* at 1137-38.

¹⁸⁶ See IRC §§ 702, 1366. Owners of other business entities are not taxed currently on the entity's current earnings; the business entity is taxed, however, on its income. See IRC §§ 11, 641. The failure to tax the owners of these taxable entities provides minimal support for not taxing the interest credited to cash values because life insurance companies are not taxed on investment income credited to their policyholders. See note 49.

¹⁸⁷ See IRC § 1272; Brannon, note 181, at 736. Short-term obligations are excluded from the scope of the original issue discount provisions. IRC § 1272(a)(2)(C).

owners in these instances, however, is not premised on the doctrine of constructive receipt.¹⁸⁸ The income is includable irrespective of the taxpayer's ability to command the receipt of cash. For example, limited partners and owners of minority interests in corporations and partnerships often lack either the legal power or the effective ability to convert the income into cash without selling the property.

The cash value of a life insurance contract, like the properties discussed above, is an asset that generates income. A life insurance company's crediting of interest constitutes compensation for its use of the policy's cash value.¹⁸⁹ The cash value reflects the interest credited, just as the values of the partnership interest, the S corporation stock, and the debt instrument with original issue discount also reflect income that has not been severed from the underlying asset. Because income derived from these other forms of property is taxed despite the lack of receipt, actual or constructive, the realization doctrine, standing alone, does not justify treating the owners of cash value life insurance contracts in a different manner.

It has also been argued that the substantial penalties resulting from surrender of a life insurance contract make it unfair to tax the interest credited prior to actual receipt.¹⁹⁰ In particular, a policyholder surrendering an existing contract who needs continuing insurance protection must prove insurability and may pay higher premiums. The asserted magnitude of this penalty is subject to question. Because premium levels

¹⁸⁸ See Reg. § 1.451-2 (discussing the elements of constructive receipt).

¹⁸⁹ See notes 35-47 and the accompanying text. The supporters of the current tax treatment assert that cash value life insurance "is a way of providing lifetime protection for families against the risk of death at a fixed cost." See 1985 Senate Hearings, note 182, at 394; see also *id.* at 345 (statement of Fred A. Deering). Although level premium life insurance serves this purpose, life insurance incorporates many of the features of a financial asset. See notes 46-47 and the accompanying text.

Excluding the interest credited under cash value life insurance from income might be appropriate if the life insurance company were overtaxed on its income. See generally Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 *Yale L.J.* 506, 519-24 (1986). There is no evidence that life insurance companies are overtaxed. See 1983 House Report, note 4, at 99-101; 1984 Senate Report, note 4, at 520-22.

The increase in the cash value of a variable life insurance contract represents the income earned by the underlying pool of assets. See Gallian & Baylor, *Federal Taxation Aspects of Variable Life Insurance*, 8 *U.S.F. L. Rev.* 523, 523-25 (1974). Concerns about realization are legitimate to the extent that changes in the cash value of a variable life insurance contract represent unrealized changes in the value of the underlying pool of assets. See *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity*, note 11, at 256.

¹⁹⁰ See 1985 Senate Hearings, note 182, at 394-97. The requirement that a policyholder surrender the contract to obtain the cash value may explain why, under current law, the owner is not in constructive receipt of the interest credited. A taxpayer is in constructive receipt of income available "without substantial restrictions or limitations." Reg. § 1.451-1. A requirement that the policyholder surrender a life insurance contract constitutes a substantial restric-

generally have declined in recent years,¹⁹¹ replacement of an existing contract may prove advantageous. Moreover, insurance companies often base their premiums on the assumption that an insured's health will deteriorate significantly over time.¹⁹² Consequently, assuming that the net amount at risk is the same under the old and the new contracts, a new medical examination may result in a premium reduction, rather than an increase.

b. Is the Current Tax Treatment of Life Insurance Necessary to Encourage Financial Security?

A second argument in support of the current tax treatment of cash value life insurance is that an incentive is needed to encourage taxpayers to provide for their families' financial security.¹⁹³ Though laudable, the objective of protecting one's family against financial adversity does not, of itself, justify preferential tax treatment.¹⁹⁴ Beyond laudability, two further criteria must be satisfied: (1) Favorable tax treatment must induce changes in taxpayer behavior that significantly advance the perceived social goal; and (2) the behavior likely to be changed must be sufficiently important to justify the revenue loss.¹⁹⁵ The goal of promoting financial security satisfies neither of these requirements.

The preferential tax treatment of investment income earned under a cash value life insurance contract is likely to induce taxpayers to invest more resources in this financial product. How does the purchase of cash value life insurance protect an individual against financial adversity? Cash value life insurance can enhance an individual's financial security by protecting against the loss of two distinct income streams. First, the contractual death benefit provides funds to replace the insured's salary in case of death before retirement. Second, the cash value provides funds that can replace a taxpayer's salary following retirement. The analysis of the current taxation of cash value life insurance requires separate consideration of each function.

Life Insurance as a Source of Post-death Income Replacement: The unique risk shifting function of life insurance relates primarily to the post-death replacement of the insured's income. A parent, for example, may be concerned that the loss of her income would leave her dependents without adequate means of support.

tion or limitation, so that the policyholder is not in constructive receipt of the interest as credited. Theodore H. Cohen, 39 T.C. 1055, 1062-63 (1963).

¹⁹¹ See K. Black & H. Skipper, note 8, at 49-50, 77-79.

¹⁹² *Id.* at 318.

¹⁹³ 1985 Senate Hearings, note 182, at 411-12; Brannon, note 181, at 736-37; Goode, note 27, at 48-49; McLure, note 34, at 392.

¹⁹⁴ Goode, note 27, at 48.

¹⁹⁵ See S. Surrey & P. McDaniel, *Tax Expenditures* 112-13 (1985).

An individual often earns both investment income and income from personal efforts. Because the insured's investment assets remain in existence following her death, cash value life insurance is not needed to replace the insured's investment income. Admittedly, the buildup of the contract's cash value increases the individual's wealth which may generate post-death investment income for an insured's dependents. Saving in the form of a life insurance contract's cash value, however, does not differ from other forms of savings in this regard. Consequently, preferential tax treatment to induce saving through the internal buildup of policy values is not justified.

The portion of the death benefit that consists of term insurance protection provides a fund that can generate investment income to replace the insured's income from personal efforts. The existence of this type of fund undeniably enhances the financial security of the insured's family. Unfortunately, existing tax incentives, perversely, are likely to induce undesirable changes in taxpayer behavior. To the extent that the tax law induces a switch from term insurance to cash value life insurance, the taxpayer is likely to obtain less insurance protection. The premium charged for a level-premium cash value life insurance contract is much larger than the initial premium for a term contract with an identical death benefit.¹⁹⁶ Unless the taxpayer greatly increases the portion of her budget allocated to life insurance, the amount of insurance protection will decline.

Paradoxically, the current tax treatment also provides the greatest tax benefit to taxpayers whose insurance needs are modest: those who can most easily afford to obtain their current insurance protection in conjunction with a savings program.¹⁹⁷ Taxpayers with substantial wealth, who can afford to purchase large amounts of single premium insurance, enjoy the largest tax benefits. Yet, the accumulated wealth of these tax-

¹⁹⁶ See K. Black & H. Skipper, note 8, at 54, 65 (illustrating annual term insurance premiums ranging between \$1.37 and \$3.19 per \$1,000 death benefit, and level premiums for a cash value contract ranging from \$12.02 to \$23.69 per \$1,000 death benefit). Although term insurance premiums increase in subsequent years, the annual cost of term insurance will not exceed the level premium for the cash value contract for many years. See *id.* at 314-15 (illustrating that the yearly probability of dying, according to the 1980 Commissioners' Standard Ordinary Mortality Table increases from .21% at age 35 to .67% at age 50 and to 1.61% at age 65); see also Consumer Reports, note 110, at 448 (reporting that the term insurance premium would not exceed the whole life level premium for more than 25 years).

The relatively lower premiums charged in later years under level premium contracts make it more likely that taxpayers will maintain their insurance protection for longer periods. It should be noted, however, that a taxpayer's insurance needs decline as one's children become financially independent. Given the disincentives discussed in the text, and the extended period during which cash value premiums exceed term premiums, the extent of the increased coverage is likely to be of minor consequence.

¹⁹⁷ See notes 32-42 and the accompanying text. The savings component of a premium may reflect either new savings on the part of the policyholder or a transfer of existing wealth from one type of investment to another.

payers makes it more likely that their families could maintain their standard of living without life insurance protection.¹⁹⁸

Less, if any, incentive is provided, however, for taxpayers with little wealth. For those taxpayers for whom single-premium policies are too expensive, but who can afford to purchase a level-premium cash value contract, the tax benefits are less generous, but are still substantial. For taxpayers who cannot afford to pay the higher premiums charged under a cash value contract, financial protection is available only in the form of term life insurance,¹⁹⁹ the cost of which, however, is not generally deductible.²⁰⁰ Because of the irrational inverse relationship between the need for insurance protection and the distribution of tax benefits, existing tax incentives to provide financial security should receive a low national budgetary priority.

Life Insurance as a Source of Retirement Income: Cash value life insurance purportedly enhances an individual's financial security by providing a source of post-retirement income. The same is true, however, of a savings account, taxable bonds, or any other savings vehicle. The income from these alternative savings vehicles generally is fully taxable on a current basis, and the savings feature of cash value life insurance provides no distinguishing characteristic that justifies more favorable tax treatment.

The perceived need to encourage savings for retirement also underlies the preferential tax treatment of qualified pension plans and IRAs.²⁰¹ The tax benefits available to participants in qualified pension plans encourage employees to seek deferred, rather than current, compensation to enhance their retirement security. These benefits are denied, however,

¹⁹⁸ One life insurance company executive testified concerning the limited role that income replacement plays in the purchase of single premium life insurance. He described a 1975 vintage sales brochure as follows:

Life insurance is only mentioned two places in the brochure, and odds are, if it could legally have been eliminated from the discussion, it would have been. The words "death benefit" appear nowhere. Advertising life insurance as a savings plan is nothing new. . . . Our recent discussions with sellers illustrate that good old fashioned reasons to buy life insurance are still the same today as they have been in the past. . . . [R]etirement, long-term health care and estate planning are still primary goals.

Single premium Life Insurance, Hearings before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 100th Cong., 2d Sess. (1988) (statement of Gordon N. Oakes).

¹⁹⁹ See K. Black & H. Skipper, note 8, at 58. Similarly, the cost of term insurance protection provided under a qualified pension plan is taxable to an employee to the extent attributable to employer contributions to the plan. Reg. § 1.72-16(b).

²⁰⁰ But see § 79, which excludes from the gross income of an employee the cost of the first \$50,000 of employer provided group term life insurance. The fact that the amount of coverage, the cost of which is excluded from income under § 79, has not increased since 1964 indicates that Congress is skeptical about the need to provide tax incentives to encourage the purchase of life insurance.

²⁰¹ See Altman, note 178, at 435-38.

if a plan ignores the retirement concerns of low and moderate income workers.²⁰² Large amounts set aside for retirement do not receive such favorable tax treatment if qualified pension plans provide benefits mainly for the owners and senior executives of the plan sponsor.²⁰³ Because the retirement security goals underlying the highly favored tax treatment of qualified plans are directed toward the employees as a group, rather than toward individual employees, they furnish minimal support for the distinctly favorable tax treatment of individual purchasers of cash value life insurance.

The tax treatment of IRAs also bespeaks limited congressional tolerance for tax incentives to encourage individuals to save for their own retirement. The Tax Reform Act of 1986 imposed substantial limitations on IRAs: The annual contribution cannot exceed \$2,000,²⁰⁴ and many taxpayers who are covered by a pension plan cannot deduct IRA contributions at all.²⁰⁵ To permit unlimited individual investment in cash value life insurance undercuts these limitations on IRA investments.²⁰⁶ These limitations indicate that the possible use of a life insurance contract's cash value as a source of post-retirement income does not justify the current favorable tax treatment of cash value life insurance.²⁰⁷

Deferred annuities are also taxed preferentially. Interest income credited under deferred annuities is not taxed currently,²⁰⁸ a policy that Congress rationalized in 1982 on the ground that deferred annuities fur-

²⁰² *Id.* at 454-56. These requirements have been criticized as not providing adequate pension benefits for a sufficiently broad range of employees. *Id.* at 500-08.

²⁰³ See IRC §§ 401(a)(5) (as amended by the Tax Reform Act of 1986), 416. See also Staff of Joint Comm. on Taxation, 98th Cong., 1st Sess. General Explanation of the Tax Reform Act of 1986, 671, 683, 688, 694 (Comm. Print 1987) [hereinafter 1986 General Explanation].

²⁰⁴ IRC §§ 219(b); 408(o).

²⁰⁵ IRC § 219(g).

²⁰⁶ For taxpayers whose IRA contributions are nondeductible, the IRA limitations are irreconcilable with the taxation of life insurance investments. Both the IRA contribution and the life insurance premium payments are nondeductible and the owners are not taxed currently on their investment earnings. Yet, the contributions to the IRA are limited, whereas the dollar amount of premium payments is not.

²⁰⁷ It has also been argued that the present tax treatment of cash value life insurance should be retained because it encourages taxpayers to increase their rate of savings. See H. Aaron, *The Peculiar Problem of Taxing Life Insurance Companies 2-4* (1983). As an empirical matter, it is questionable whether the existing tax treatment of cash value life insurance has increased aggregate savings in the United States. It is more likely that the existing tax treatment diverted savings from other forms of savings toward cash value life insurance. See McLure, note 34, at 387-88. Moreover, the lack of a "general social acceptance" of the need for savings incentives in the Internal Revenue Code noted by McLure has not changed. See *id.* at 392; see also 1986 Act § 1101(a)(1) (limiting the amount deductible by active participants in certain pension plans for contributions made to individual retirement accounts).

²⁰⁸ See 1982 General Explanation, note 149, at 360. If the period of deferral is sufficient, the economic benefits of deferral more than offset the impact of the 10% withdrawal penalty. See Coppage & French, *IRAs: Break-Even Analysis After Tax Reform*, 42 *Tax Notes* 215 (1989). For taxpayers approaching retirement, the likely absence of any withdrawal penalty increases the net benefit of deferral.

ther "long-term investment and retirement goals."²⁰⁹ During its consideration of the Tax Reform Act of 1986, however, Congress decided that these policy goals were not sufficiently important either to warrant allowing pension plan participants to invest in IRAs on a deductible basis,²¹⁰ or to remove the \$2,000 ceiling on IRA contributions, whether or not deductible. The policy justification for the treatment of deferred annuities has been called into question and provides, at best, only the weakest support for the current taxation of life insurance.²¹¹

Moreover, annuities are subject to numerous provisions designed to ensure that the savings are used for retirement. For example, cash withdrawals and loans from annuity contracts are treated first as taxable distributions and, in certain instances, are subject to a penalty tax.²¹² In addition, the taxation of interest credited to a deferred annuity is not forgiven upon the death of the annuitant.²¹³ Thus, this interest will be subject to taxation at some later date. The failure to subject life insurance contracts to comparable provisions is inconsistent with its purported retirement security purpose.

In sum, tax policy concerns do not justify the current tax treatment of cash value life insurance for three reasons. First, current law creates a perverse set of incentives that may actually reduce the financial security of our citizenry. Second, the tax incentives apply in an upside-down manner: The greatest benefits inure to the wealthiest taxpayers who have the least need for insurance protection; smaller, but still important, benefits flow to those whose insurance needs are modest; and those whose insurance needs are greatest receive no benefit at all. Third, in terms of providing post-retirement income security, a life insurance contract's cash value is indistinguishable from other forms of savings, the income from which is taxed currently.

²⁰⁹ *Id.* at 361.

²¹⁰ See 1986 General Explanation, note 203, at 625-26.

²¹¹ Admittedly, Congress refused to adopt President Reagan's proposal to tax currently any increase in the cash value of a deferred annuity contract. See *The President's Tax Proposals to the Congress*, note 11, at 259-60. Nothing in the legislative history of the 1986 Act, however, suggests that Congress' balkiness was based on policy grounds. In 1988, Congress ordered the Treasury Department and the General Accounting Office to study the policy justification for preferential taxation of both cash value life insurance contracts and annuities in light of the reforms made by the Tax Reform Act of 1986. 1988 Technical Corrections Act § 5014(a)(2).

Moreover, the mere fact of congressional continuation of tax preferred status for the owners of deferred annuities does not in itself provide a policy rationale for that action or for the current taxation of cash value life insurance. It means only that Congress has compounded the problem by winking without objection at a second related set of tax rules that are as unjustifiable as the first. Here, as elsewhere, two wrongs don't make a right.

²¹² IRC § 72(e)(2), (4)(A), (q).

²¹³ See IRC § 1014(b)(9)(A); Rev. Rul. 79-335, 1979-2 C.B. 292.

c. Would Current Taxation Create Excessive Administrative Burdens?

A third argument raised in defense of the existing tax treatment accorded life insurance is that taxing the interest as earned would create unmanageable administrative burdens.²¹⁴ This argument combines two distinct issues. First, concern is expressed that life insurance companies would be saddled with excessive administrative burdens if they were required to compute and report the amount of income credited to each life insurance contract.²¹⁵ Although these concerns may have been valid in the past, they have significantly less legitimacy today.²¹⁶ Life insurance companies issue reports in connection with universal life insurance contracts that provide month-by-month breakdowns of premiums received, charges imposed, interest credited, and policy cash values.²¹⁷ In addition, life insurance companies must report the amount of income recognized by a policyholder as a result of the surrender or exchange of a life insurance contract.²¹⁸ The industry's existing computerized record keeping and reporting systems indicate that compliance with a current taxation regime is feasible.²¹⁹

Second, commentators have disagreed about the measure of income that is properly subject to tax. The commentators have proposed that the policyholder's income reflect changes in either the cash surrender value of the contract or the life insurance company's reserve liability maintained with respect to the contract.²²⁰ This disagreement may reflect that, prior to 1948, cash values were linked directly to the reserve liabilities established with respect to the contract.²²¹ At present, the company's reserve liability represents a present value estimate of the company's future liabilities, rather than the value of the policyholder's asset.²²² In addition, ease of computation makes the cash value a more convenient measuring rod of the interest credited during any given year.²²³

²¹⁴ See Brannon, note 181 at 736; Goode, note 27, at 49-53; McLure, note 34, at 395-99.

²¹⁵ See 1985 Senate Hearings, note 182, at 412-13.

²¹⁶ See McLure, note 34, at 396-97; Shakow, note 184, at 1138.

²¹⁷ See K. Black & H. Skipper, note 8, at 85-86.

²¹⁸ IRC § 3405; Temp. Reg. § 35.3405-1 at E-8, F-24.

²¹⁹ Use of transition rules could mitigate the administrative burdens of taxing interest credited under cash value life insurance contracts. Alternatively, grandfathering of certain older contracts of de minimis size could provide an alternative mechanism to reduce administrative burdens. See Temp. Reg. § 35.3405-1 at F-24.

²²⁰ See Vickrey, note 2, at 565-67.

²²¹ See *id.* at 562 n.15; see also K. Black & H. Skipper, note 8, at 358.

²²² K. Black & H. Skipper, note 8, at 358.

²²³ See Goode, note 27, at 50; McLure, note 34, at 397 n.87.

d. Does the Existing Tax Treatment of Cash Value Life Insurance Improve Vertical Equity?

The defenders of preferential tax treatment of cash value life insurance argue, fourthly, that the benefits accrue to the middle class, thereby providing a degree of vertical equity for these taxpayers compared to the wealthy.²²⁴ Even if the current life insurance tax regime primarily benefits the middle class,²²⁵ it is not clear, following the enactment of the Tax Reform Act of 1986, that vertical equity is enhanced by retaining this tax treatment. Enactment of provisions that limit the benefits of most tax sheltered investments,²²⁶ as well as the expanded scope of the alternative minimum tax, limit the extent to which (or at least the ease with which) the wealthy can substantially reduce their tax liabilities. Indeed, investments in cash value life insurance are currently promoted as one of the last remaining tax favored investments.²²⁷

2. Analysis and Evaluation of Life Insurance Distribution Rules

a. Stacking Rules and Policy Loans

The owner of a life insurance contract (other than a modified endowment contract) may receive substantial amounts of cash without including any amount in income. Cash distributions from such a life insurance contract are excluded from gross income until the aggregate amount received exceeds the policyholder's investment in the contract.²²⁸ If cash is received as a policy loan, no amount is includable in the policyholder's

²²⁴ See 1985 Senate Hearings, note 182, at 406-09; McLure, note 34, at 392. This defense has been characterized as "a sad commentary on the state of tax equity in the United States." *Id.*

²²⁵ The data presented in support of this claim by the American Council on Life Insurance focuses on the percentage of life insurance contracts purchased in 1983 by individuals with income of \$25,000 or less. 1985 Senate Hearings, note 182, at 406. No data is presented showing the percentage of the tax savings enjoyed by taxpayers in different income classes.

In addition, the 1983 data does not reflect the subsequent explosive growth in the sale of single premium life insurance contracts: From 1984 to 1986, premiums paid for single premium life insurance contracts increased from \$1.0 billion to \$4.4 billion. U.S. General Accounting Office, *Taxation of Single Premium Life Insurance* 17 (1987). During the first 6 months of 1987, premiums paid for single premium contracts increased to \$4.4 billion. In 1985, the average single premium paid was \$31,000. *Id.*

²²⁶ See IRC §§ 55, 163(d), 469.

²²⁷ See, e.g., Rankin, *Using Life Insurance as a Tax Shelter*, N.Y. Times, May 10, 1987, § 3, at 11; Quinn, *The Tax Game in Insurance*, Newsweek, Nov. 10, 1986, at 60; King & Farrell, *There's More Life in Life Insurance Thanks to Tax Reform*, Business Week, Dec. 29, 1986, at 126. These articles focus on the benefits of single premium life insurance contracts. See also McCormick, *Life Insurance Products After The Tax Reform Act of 1986*, Insurance Tax Review, March-April 1987, at 13-16.

²²⁸ IRC § 72(e)(5). See also IRC § 72(e)(10) and notes 50-51 and the accompanying text (discussing the stacking rules applicable to life insurance contracts and to modified endowment contracts).

income.²²⁹ Even accepting the argument that interest credited to the cash value of a life insurance contract should not be taxed currently, it is doubtful that deferral of taxation should continue after the policyholder receives cash or another economic benefit under the contract.

Deferral of income permitted under other tax deferred savings vehicles does not survive a taxpayer's receipt of cash. The stacking rules applicable to preretirement distributions in connection with certain qualified pension plans require that a taxpayer who receives a distribution must include at least a portion of the amount received in income.²³⁰ Moreover, loans from pension plans and from IRAs are treated as distributions in many instances, as are loans under deferred annuity or modified endowment contracts.²³¹ There is no apparent justification for treating distributions of cash from a life insurance contract more favorably than distributions from pension plans, IRAs, or deferred annuities. These savings vehicles are treated favorably under the income tax laws to encourage savings that will produce post-retirement income. Congress has recognized that favorable tax treatment is no longer justified, however, if the funds are used for purposes unrelated to retirement.²³²

In the case of cash value life insurance, the goal is to foster provision of financial security for the insured's family in case of the insured's death. Cash distributed under a life insurance contract, however, no longer provides financial security for the insured's beneficiaries. As with distributions from pension plans, IRAs, and deferred annuities, continued deferral of taxation is no longer justified. Accordingly, amounts received as policy loans should be treated as a distribution under the contract.

²²⁹ See notes 52-56 and the accompanying text. Loans from, or secured by, a modified endowment contract are treated as taxable distributions rather than bona fide loans. See IRC § 72(e)(10).

²³⁰ See IRC § 72(e)(8). A pro rata portion of the distribution is treated as a tax-free return of the taxpayer's investment in the contract (IRC § 72(e)(6)) with the remainder included in the taxpayer's income. The allocation of the distribution between nontaxable and taxable amounts will be in proportion to the ratio of the taxpayer's investment in the contract to the value of the taxpayer's rights under the pension plan. S. Rep. No. 313, 99th Cong., 2d Sess. 610 (1986), reprinted in 1986-3 C.B. (vol. 3) 610 [hereinafter 1986 Senate Report].

²³¹ Section 72(e)(4)(A) provides that any amount received as a loan under an annuity contract, or received as a loan for which an annuity contract is pledged as security, is treated as a distribution from the annuity contract. Section 72(e)(10) subjects modified endowment contracts to the same distribution and loan characterization rules.

Similarly, an individual who uses an IRA as security for a loan is treated as having received a distribution in the amount of the loan so secured. IRC § 408(e)(4). Similar, but less strict rules apply to loans from qualified pension plans. IRC § 72(p).

In 1983, the Treasury Department suggested that limitations on the use of policy loans under life insurance contracts be enacted using the rules governing loans from qualified employer plans as a model. See 1983 Hearings, note 39, at 16-17. Neither the House of Representatives nor the Senate acted favorably on the Treasury Department's suggested use of the qualified plan rules. Limitations on the deductibility of interest on life insurance policy loans, however, were enacted as part of the Tax Reform Act of 1986. See note 55.

²³² See 1986 Senate Report, note 230, at 613; note 201 and the accompanying text.

Similarly, the stacking rule used to determine whether the distribution is treated as a tax-free return of the taxpayer's capital or as a taxable distribution of the interest credited under the policy should be revised.²³³

b. Effect of Mortality Charges on the Proper Measure of Income

A related question concerns the proper treatment of charges imposed for current insurance protection under a life insurance contract. Under present law, the maximum amount included in income is the excess of the contractual cash value over the policyholder's investment in the contract.²³⁴ Payment of the mortality charges reduces the cash value. As a result, the amount included in income upon the surrender of a life insurance contract understates the interest credited by the cumulative amount of these charges.²³⁵

Using the cash value to pay mortality charges is functionally equivalent to making a cash distribution to a policyholder who then pays the mortality charges directly. Absent special considerations, the in-kind economic benefit provided to the policyholder should produce the same tax consequences. Depending on the applicable stacking rules, the deemed cash distribution would be treated either as income or as a return of the policyholder's investment in the contract. Because the cost of life insurance generally is a nondeductible personal expense for tax purposes,²³⁶ the deemed payment of the mortality charges would not produce an offsetting tax deduction. It is arguable whether use of this substance over form analysis is appropriate in connection with the payment of mortality charges under a cash value life insurance contract. To treat the payment of mortality charges as a deemed distribution is inconsistent with the presumed rationale for not taxing the interest credited currently, i.e., that individuals should be encouraged to provide for the

²³³ The fact that the 1988 Technical Corrections Act enacted the suggested distribution rules solely for modified endowment contracts does not demonstrate that Congress should not extend these rules to all life insurance contracts. The modified endowment rules represent Congress' response to the explosive growth in sales of single premium contracts marketed as tax sheltered investment vehicles. See H.R. Rep. No. 795, 100th Cong., 2d Sess. 476-77 (1988). Congress evidenced its continuing concern in this area when it ordered the Treasury Department and the General Accounting Office to study "the policy justification for, and the practical implications of, the present-law treatment of the earnings of the cash surrender value of life insurance contracts in light of the reforms made by the Tax Reform Act of 1986." 1988 Technical Corrections Act § 5014(a)(2).

²³⁴ See notes 59-62 and the accompanying text.

²³⁵ *Id.*

²³⁶ See Reg. § 1.262-1(b)(1). In addition, no deduction is allowed for certain life insurance premiums paid in connection with the taxpayer's trade or business if the taxpayer is a direct or indirect beneficiary of the contract. See IRC § 264(a)(1); Reg. § 1.264-1.

financial security of their families.²³⁷ Amounts expended for mortality charges further the statutory goal.

3. *Analysis and Evaluation of Section 7702's Limitations on Investment-Oriented Life Insurance Contracts*

a. *Use of the Single Premium Model of Acceptable Investment Orientation*

During the early 1980's, life insurance companies marketed contracts providing de minimis current insurance protection. Section 7702's definition of life insurance was designed to deny life insurance status to overly investment-oriented products without affecting the preferential tax treatment for most life insurance product designs marketed prior to the 1980's.²³⁸ To achieve this result, § 7702 uses the single premium contract as the maximum limit of investment orientation. The threshold question in evaluating § 7702 is whether its single premium model allows excessive investment orientation. If so, the balance in § 7702 between the investment and insurance components of life insurance should be revised.

The reasonableness of the permitted degree of investment orientation depends on the rationale for preferential treatment of life insurance. The family protection rationale is the most plausible.²³⁹ If the tax benefits are disproportionate to the cost of insurance protection provided, § 7702 permits excessive investment orientation.

The single premium contract examined earlier is representative of the investment orientation of single premium life insurance contracts.²⁴⁰ Assuming that interest is credited at a rate of only 4%,²⁴¹ the interest credited in each of the first 35 years that the contract is in force is more than twice the level of the charges imposed for current insurance protection. During each of the first 20 years, more than \$3 of interest is credited for each dollar charged for current insurance protection.

If interest were credited at rates closer to market interest rates, the relative amounts of interest credited, compared to the charges for current insurance protection, would be even greater. For example, if interest is credited at an 8% rate, during each of the first 20 years more than \$6 of interest would be credited for each dollar charged for current insurance

²³⁷ But see notes 182-213 and the accompanying text (evaluating whether the tax policy arguments raised in defense of the existing tax treatment of cash value life insurance withstand scrutiny).

²³⁸ See 1983 House Report, note 4, at 146; 1984 Senate Report, note 4, at 573.

²³⁹ See notes 193-200 and the accompanying text.

²⁴⁰ See the text accompanying note 45; see also Appendix Table 2.

²⁴¹ See note 39.

protection; during the first 15 years the ratio would exceed 8-to-1.²⁴² As is apparent, a substantial investment element exists under a single premium contract.

In many instances, the tax revenue forgone due to the failure to tax the interest credited under a single premium policy exceeds the cost that the government would incur if it purchased the insurance protection and provided it to the policyholder without charge.²⁴³ Assuming that interest is credited at a rate of 8%, for a taxpayer in the 15% tax bracket, at least \$1.20 of tax revenue is forgone to provide term insurance protection that costs \$1. For a taxpayer in the 28% tax bracket, tax revenues of \$3.36 are forgone to produce term insurance protection that costs \$1. Even if interest is credited at only a 4% rate for a taxpayer in the 28% marginal tax bracket, the tax revenue forgone exceeds the cost of current insurance protection for more than 15 years.

Under the single premium contract, the tax revenue forgone is indisputably disproportionate to the social benefit of encouraging term insurance protection. The statutory definition of life insurance should require a more reasonable balance between the expected amount of interest credited and the cost of current insurance protection provided. Where the income tax laws are used to encourage certain behavior, the tax incentive provision rarely produces tax savings that exceed the savings that would be generated from deducting the cost of purchasing the tax favored activity.²⁴⁴ Applying this standard to the definition of life insurance, the amount of interest credited that is not taxed should not exceed the cost of current insurance protection provided. This balance could be achieved by specifying, in tabular form, maximum ratios of cash value to death benefit that would apply at all ages, such as those that approximate the ratios under a level premium policy.²⁴⁵

²⁴² Reductions in the charges for current insurance protection would also increase the relative amount of interest credited under the contract.

²⁴³ This phenomenon is illustrated using the single premium contract discussed at note 45 and the accompanying text. See Appendix Table 2.

²⁴⁴ See, e.g., IRC §§ 21 (credit for dependent care limited to 30% of employment related expenses), 106 (exclusion from employee's income of employer paid premiums for health insurance); see also S. Rep. No. 494, 98th Cong., 2d Sess. 122 (1982) (explaining that the combined tax benefits from the investment tax credit and cost recovery deductions under the accelerated cost recovery system (ACRS) were excessive because they exceeded the tax benefits of expensing). But see IRC § 28 (providing a 50% credit for the costs of testing certain orphan drugs).

²⁴⁵ See 1983 Hearings, note 39, at 521-22. These ratios could be relaxed to allow a degree of flexibility concerning the timing of premium payments, as is allowed under the typical universal life insurance policy.

b. The Actuarial Requirements of Section 7702

Because § 7702 codified most existing life insurance policy designs, it is necessarily based on actuarial principles. The result is an extremely complex provision that can potentially be avoided by manipulating actuarial assumptions to increase the investment orientation of contracts. Although § 7702 establishes limits,²⁴⁶ the range of permissible actuarial assumptions may nonetheless remain unduly generous.

For purposes of computing the tax net single premium and the guideline level premium, an interest rate as low as 4% may be used.²⁴⁷ Although it is difficult to determine an appropriate interest rate, it is likely that this 4% rate significantly understates the interest that will be credited to a contract's cash value and, correspondingly, tolerates excessive maximum cash values (or premium payments).

The treatment of the actuarial assumptions concerning mortality and expense charges in § 7702 is also flawed. Only "reasonable" charges are used in computing the tax net single premium and the guideline premiums.²⁴⁸ Even if the charges are reasonable, they may exceed the amounts that the policyholder effectively pays. Although § 7702 requires that the expense charges and, for certain contracts, mortality charges are reasonably expected to be imposed by the company,²⁴⁹ life insurance companies may attempt to offset excessive charges with additional credits of investment income.

A second question concerns the use in § 7702 of alternative general actuarial limitations. The two limitations are modeled on, and were intended to accommodate, different life insurance policy designs. The cash value accumulation test is patterned on the traditional participating cash value life insurance contract.²⁵⁰ The guideline premium limitation/cash value corridor reflects the universal life insurance policy design.²⁵¹

Use of the dual limitations creates disparities that are difficult to justify. At the outset of the contract, the use of the 4% interest rate assumption allowed in computing the tax net single premium (rather than the 6% minimum rate required in computing the guideline single premium) permits a greater infusion of cash into the policy than is allowed under the guideline premium test. In later years, the guideline premium/cash value corridor test allows the cash value to increase to a larger percentage of the current death benefit than is permitted under the cash

²⁴⁶ See notes 112-29 and 150-61 and the accompanying text; see also Part II.

²⁴⁷ IRC § 7702(b)(2)(A), (c)(4).

²⁴⁸ See IRC § 7702(c)(3)(b)(i) and (ii); notes 126-29 and 158-61 and the accompanying text.

²⁴⁹ IRC § 7702(c)(3)(B)(ii); 1988 Technical Corrections Act § 5011(c)(2).

²⁵⁰ See notes 93-95 and the accompanying text.

²⁵¹ See note 135 and the accompanying text.

value accumulation test.²⁵²

Whether the creation of these disparities is a serious shortcoming depends on the benefits produced by the presence of the dual tests. The need for two separate tests is not clear. The cash value accumulation test carries out one of the congressional goals: Traditional cash value policy designs can satisfy its requirements without modification. It has been suggested that the cash value corridor creates a degree of flexibility needed under universal life insurance contracts that is not available under the cash value accumulation test.²⁵³ In particular, it is claimed that a cash value corridor that allows relatively small amounts of current insurance protection is needed to protect life insurance companies against the risk that existing policyholders in poor health would increase the amount of current insurance protection at bargain prices. While this fear represents a legitimate business concern for the life insurance companies, it does not provide a compelling justification for the use of an ineffective cash value corridor. Life insurance contracts, including universal life insurance, typically limit the extent to which the death benefit can be increased without evidence that the insured's health is acceptable.²⁵⁴ Such a limitation, rather than the virtual elimination of the insurance features of the contract, is the more appropriate method to protect against adverse selection.

II. ACTUARIAL SAFEGUARDS

A. *Definition of Future Benefits*

1. *Statutory Definition of Future Benefits*

The limitations contained in both the cash value accumulation test and the guideline premium limitation test are calculated with reference to the "future benefits under the contract."²⁵⁵ Under both tests, the level of future benefits determines the premiums that the policyholder is permitted to pay.²⁵⁶ Consequently, the range of benefits included within the definition of the term "future benefits" assumes great importance. Most significantly, this definition limits the types of benefits that the insured

²⁵² An additional disparity is that different adjustment rules apply under the two limitations when the benefits provided under the life insurance contract are changed after the contract is issued. See notes 322-27 and 334-42 and the accompanying text. These differences are analyzed in notes 328-33 and 343-68 and the accompanying text.

²⁵³ See note 142; see also 1983 House Hearings, note 39, at 569-74 (statement of Hartzel Z. Lebed).

²⁵⁴ See K. Black & H. Skipper, note 8, at 88.

²⁵⁵ IRC § 7702(b)(1), (c)(3)(A).

²⁵⁶ See notes 90-91 and 145-49 and the accompanying text.

can purchase with the untaxed interest credited under a life insurance contract.

The two basic future benefits under the contract²⁵⁷ are the death benefit (the amount payable due to the insured's death)²⁵⁸ and the endowment benefit (the amount payable if the insured survives until the policy terminates).²⁵⁹ In addition to the basic death and endowment benefits, a purchaser of a life insurance contract can obtain additional insurance protection in the form of supplemental contracts, or "riders," for which additional premiums are charged.²⁶⁰ Among the most common additional benefits provided are: (1) disability waiver of premiums; (2) accidental death benefit, or "double indemnity"; and (3) guaranteed insurability.²⁶¹

Section 7702 characterizes insurance protection provided in supplemental contracts as an additional benefit.²⁶² The effect on the tax net single premium and the guideline premiums depends on whether the additional benefit is "qualified."²⁶³ Qualified additional benefits are guaranteed insurability, accidental death or disability, disability waiver benefits, and family term coverage.²⁶⁴ Although these are not treated as future benefits for purposes of computing the tax net single premium and the guideline premium,²⁶⁵ the charges for them specified in the contract are treated as future benefits.²⁶⁶ As a result, the presence of a qualified additional benefit increases the maximum allowable cash value (or guideline single premium) in an amount equal to the tax net single premium (or the guideline single premium) for the qualified additional benefit.

The second category of additional benefits is a catchall that includes all

²⁵⁷ IRC § 7702(f)(4).

²⁵⁸ IRC § 7702(f)(3). The death benefit does not include any qualified additional benefit payable due to the death of the insured. *Id.* An accidental death benefit is a qualified additional benefit. IRC § 7702(f)(5)(A)(ii). Consequently, the portion of the death benefit payable solely on account of the accidental nature of the insured's death is not a future benefit under the contract. See 1983 House Report, note 4, at 146; 1984 Senate Report, note 4, at 577; see also notes 263-66 and the accompanying text (discussing the treatment of qualified additional benefits).

²⁵⁹ J. Belth, note 41, at 42.

²⁶⁰ K. Black & H. Skipper, note 8, at 113; J. Belth, note 41, at 29.

²⁶¹ K. Black & H. Skipper, note 8, at 113-16; J. Belth, note 41, at 29-32. Guaranteed insurability gives the insured the right to purchase additional amounts of insurance at specified dates without providing evidence of insurability. K. Black & H. Skipper, note 8, at 115.

²⁶² IRC § 7702(f)(5).

²⁶³ IRC § 7702(f)(5)(A).

²⁶⁴ *Id.* Other benefits are treated as qualified additional benefits only to the extent provided in regulations prescribed by the Treasury Department. IRC § 7702(f)(5)(A)(v). The discussions of qualified additional benefits in the applicable committee reports do not discuss the criteria to be used in exercising this regulatory authority. See 1983 House Report, note 4, at 146-47; 1984 Senate Report, note 4, at 574.

²⁶⁵ IRC § 7702(f)(5)(B).

²⁶⁶ *Id.*

benefits other than qualified additional benefits.²⁶⁷ Section 7702 separates supplemental contracts containing nonqualified benefits from the contract containing the basic benefits and the qualified additional benefits. The cost of the nonqualified benefits is not treated as a future benefit for purposes of the tax net single premium and the guideline premiums. As a result, the presence of these benefits does not affect the maximum amount of premiums payable under the contract. In addition, any amount paid currently for these benefits is not treated as a premium payment for purposes of the guideline premium limitation.²⁶⁸

2. *Analysis of the Treatment of Additional Benefits*

The creation of two categories of additional benefits represents legislative line drawing. Premiums paid for qualified additional benefits can generate interest that receives the beneficial tax treatment accorded the basic benefits under a life insurance contract, while the other additional benefits do not. Thus, the distinction between qualified and nonqualified additional benefits restricts the type of insurance that can be purchased with untaxed interest earnings. Interest earnings pay for insurance benefits only if prior premium payments allocable to the qualified benefit exceeded the current charge for that benefit. The excess is added to the contract's cash value which, when credited with interest, may pay for the cost of the additional benefits in subsequent years.²⁶⁹

In evaluating this treatment of additional benefits, the threshold question is whether the existing tax treatment of interest credited under a life insurance contract is warranted.²⁷⁰ Even assuming it is, further analysis is needed because the rationale for that conclusion does not necessarily extend to particular additional benefits.²⁷¹

The tax treatment of interest accumulated under a life insurance contract differs radically from the general treatment of other forms of interest income.²⁷² For this reason, it is appropriate to limit the uses of accumulated interest to those types of insurance that are closely related

²⁶⁷ The only additional benefit discussed in the committee reports that is not a qualified additional benefit is "business term insurance." 1983 House Report, note 4, at 147; 1984 Senate Report, note 4, at 574.

²⁶⁸ IRC § 7702(f)(5)(C)(ii). Any amount that the policyholder pays prior to the period of coverage for a nonqualified additional benefit is treated as a premium payment for the other benefits under the policy.

²⁶⁹ See notes 35-45 and the accompanying text.

²⁷⁰ See notes 171-227 and the accompanying text (evaluating the tax policy justification for the current treatment of interest credited under a cash value life insurance contract).

²⁷¹ In addition to the qualified additional benefits listed in IRC § 7702(f)(5)(A)(i)-(iv), regulations may classify other benefits as qualified additional benefits. IRC § 7702(f)(5)(A)(v). A similar analysis to that contained in the text is appropriate in deciding whether to exercise this regulatory authority.

²⁷² See notes 175-80 and the accompanying text.

to traditional life insurance protection. In addition, safeguards are necessary to guarantee that the ability to prefund additional benefits will not artificially increase the investment orientation of a policy beyond that permitted under the actuarial limitations for the basic benefits. These conditions are met if three criteria are satisfied.

First, the basic death benefits and the additional benefits in question should be qualitatively similar. This similarity exists if a separate contract containing only the additional benefit would enjoy the status of a life insurance contract.²⁷³ Restricting qualified additional benefits in this manner prevents untaxed interest credited under a life insurance contract from being used to pay for a wide variety of personal expenses.

Applying this qualitative similarity requirement to the list of qualified additional benefits yields inconsistent results. The family term coverage and the accidental death benefits are qualitatively similar to the basic death benefit. Under both of these types of supplemental contracts, the policy beneficiary receives specified dollar payments upon the death of an insured individual.²⁷⁴ The disability waiver benefit and the accidental disability benefit, however, appear qualitatively different from the basic death benefit. Both of these supplementary contracts provide an economic benefit when the insured becomes disabled, rather than when the insured dies.²⁷⁵ Although benefits received under an individual disability insurance policy are generally excluded from gross income,²⁷⁶ this exclusion does not provide an adequate justification for treating disability income insurance in the same manner as life insurance. The exclusion of the benefit payment from gross income is only one of the favorable tax attributes accorded life insurance.²⁷⁷

Inclusion of the disability type benefits in the tax favored category of qualified additional benefits reflects the custom of the life insurance market more than reasoned tax policy analysis. Supplementary contracts

²⁷³ For purposes of analyzing whether a separate contract containing the additional benefit is treated as a life insurance contract, it is assumed that either the cash value accumulation test or the guideline premium/cash value corridor test is satisfied.

²⁷⁴ K. Black & H. Skipper, note 8, at 114, 116.

²⁷⁵ Under a disability waiver, the policyholder is relieved of the obligation to pay premiums (or mortality charges under a universal life contract) if the insured becomes disabled. K. Black & H. Skipper, note 8, at 113-14. The effect of this waiver on the policyholder is the same as if two separate transactions had occurred. In the first transaction, the policyholder receives a benefit payment under a disability insurance contract in an amount equal to the premium due under the life insurance policy. *Id.* In the second transaction, the policyholder uses the benefit received to pay the life insurance premium. *Id.* Similarly, under the accidental disability benefit, a cash payment is made if the insured becomes disabled as a result of an accident. This type of benefit is closer to pure disability insurance because the benefit payment is not constructively paid back to the life insurance company.

²⁷⁶ See IRC § 104(a)(3).

²⁷⁷ See notes 49-64 and the accompanying text (discussing the tax treatment of life insurance policyholders).

containing disability benefits were commonly sold in conjunction with life insurance contracts prior to the enactment of § 7702.²⁷⁸ In addition, treating these additional benefits as qualified additional benefits may have a *de minimis* effect on the guideline premium and the cash value accumulation limitations.²⁷⁹ Consequently, the treatment of these disability related benefits may reflect the codification of an existing practice, rather than a principled basis for future regulatory action.

The second recommended precondition to qualified additional benefit status is that the charges reflected in the computation of the tax net single premium and the guideline premiums fairly approximate the likely charges that will be imposed. As with the mortality charges imposed for the basic death benefit, reasonable charges specified in the contract are used to compute the tax net single premium and the guideline premium limitation.²⁸⁰ For contracts issued prior to October 21, 1988, no express limitations are imposed on the charges specified in the contract for the qualified additional benefits. As discussed above, use of excessive charges in computing the tax net single premium and the guideline premiums permits the investment of additional cash in the policy, thereby increasing the investment orientation of the policy.²⁸¹ Possible challenges to excessive charges are also applicable to the charges specified for the qualified additional benefits.²⁸²

Third, qualified additional benefit status should be denied in the absence of safeguards to eliminate any undue benefit if charges for future additional benefits are reflected in computing the limitations, but the future benefits are, in fact, not provided under the contract. The possibility of undue benefit is illustrated through consideration of a contract that includes term insurance coverage for an additional family member. Because family term coverage is a qualified additional benefit, the tax net single premium includes the tax net single premiums for both the basic benefits and the cost of term coverage for the family member. Similarly, the guideline premiums include the guideline premiums for the cost of the family term insurance. If, after the policy is in effect for one year, the term coverage is canceled, then the tax net single premium (and the guideline premiums) initially computed is excessive.

This problem arises in the context of both additional benefits and basic benefits under the policy. In both cases, assumed patterns of future bene-

²⁷⁸ See K. Black & H. Skipper, note 8, at 113.

²⁷⁹ The disability benefits typically pertain to total and permanent disability. K. Black & H. Skipper, note 8, at 113-14.

²⁸⁰ 1983 House Report, note 4, at 146; 1984 Senate Report, note 4, at 574. For contracts issued after October 21, 1988, charges for qualified additional benefits are reflected in the tax net single premium and the guideline premiums only if the charges are reasonable.

²⁸¹ See notes 115-22 & 158-60 and the accompanying text.

²⁸² See notes 122-25 and the accompanying text.

fits that differ from the actual pattern of benefits provided may inflate the initial tax net single premium and guideline premiums. The adjustment provisions deal generally with this problem,²⁸³ but, as discussed below, they create an ineffective deterrent against strategies designed to increase the tax net single premium and the guideline premiums.

B. Computational Rules

Unrestricted use of actuarial assumptions in computing the tax net single premium and the guideline premiums might result in the avoidance of meaningful limits on the investment orientation of life insurance contracts. The limitation on the use of unduly low interest rate assumptions illustrates Congress's concern in this area.²⁸⁴ Similarly, the statutory "computational rules"²⁸⁵ prevent actuarial gimmicks from upsetting the intended balance between the investment and current insurance components of life insurance contracts.²⁸⁶

Under the first computational rule, the death benefit is deemed not to increase.²⁸⁷ To illustrate the effect of this rule, consider a contract which pays a death benefit of \$100,000 if the insured dies within 5 years of the issuance of the contract. After the initial 5-year period, the death benefit increases automatically to \$150,000. Under the first computational rule, the tax net single premium and the guideline premiums are computed as if the death benefit remained at \$100,000.²⁸⁸ The increase in the death benefit from \$100,000 to \$150,000, scheduled to occur after 5 years, is ignored until the increase actually occurs, at which time the increase is an adjustment.²⁸⁹

In the absence of this computational rule, the tax net single premium and the guideline premiums would reflect the increasing death benefits

²⁸³ IRC § 7702(f)(7). The adjustment provisions that apply to situations where benefits are eliminated are discussed and analyzed in notes 334-426 and the accompanying text.

²⁸⁴ See notes 112-18 and the accompanying text.

²⁸⁵ IRC § 7702(e).

²⁸⁶ See 1984 General Explanation, note 80, at 651.

²⁸⁷ IRC § 7702(e)(1)(A). This computational rule also provides that any qualified additional benefit is deemed not to increase. *Id.* The qualified additional benefits are discussed in notes 263-82 and the accompanying text.

²⁸⁸ The first computational rule does not prevent a life insurance company from issuing a contract under which the death benefit increases in the manner described in the text. See 1984 General Explanation, note 80, at 651. The computational rules only govern whether the increased benefits are reflected in the computation of the net single premium and the guideline premiums. A contract in which the death benefit increases is treated as life insurance under § 7702 if the requirements of either test are satisfied. For example, a single premium contract that restricts the premium to an amount significantly below the tax net single premium for the scheduled increased death benefits satisfies the requirements of the cash value accumulation test if the cash value of the policy can never exceed the tax net single premium for the current death benefit.

²⁸⁹ See notes 324-27 and the accompanying text.

specified in the policy.²⁹⁰ If the death benefits increase each year by a percentage that is sufficiently close to the assumed interest rate used to compute the tax net single premium, then the tax net single premium will always approximate the death benefit under the contract.²⁹¹ Consequently, the cash value of this policy could approximate the death benefit, resulting in the virtual elimination of all current insurance protection. The first computational rule maintains the intended balance between current insurance protection and cash value.

Although the computational rules generally disregard increases in the death benefit, one limited exception²⁹² allows life insurance companies to market a "return of cash value" contract that qualifies for favorable tax treatment.²⁹³ Under a return of cash value contract, the death benefit equals the sum of (1) a fixed dollar amount of current insurance protection, plus (2) the cash value of the policy immediately before the death of the insured. This life insurance contract design was developed in response to criticism that cash value life insurance deprives policy beneficiaries of the policy's predeath cash value. This criticism is based on the perception that the policy provides for both a fixed death benefit and a cash value. When the beneficiaries receive only the death benefit upon the insured's death, the cash value appears to disappear.

Because the amount of current insurance protection remains constant under a return of cash value contract, the death benefit increases as the cash value of the contract increases. The guideline premiums and the tax net single premium computed for this type of contract do not usually reflect these anticipated increases in the death benefit. Consequently, the permissible premiums (or cash value) may be insufficient to generate the contract's cash value and death benefits.²⁹⁴ The effect of the limited ex-

²⁹⁰ Both the tax net single premium and the guideline premiums are computed with reference to the future benefits under the contract. IRC § 7702(b)(1), (c)(3)(A). The future benefits under the contract include the death benefits. IRC § 7702(f)(4).

²⁹¹ See 1983 Hearings, note 39, at 29. In the extreme case where the two rates are equal, the net single premium equals the death benefit at all times. In this extreme case, the contract is solely an investment; no current insurance protection is provided.

An increasing pattern of death benefits would not eliminate the current insurance component of a contract tested under the guideline premium/cash value corridor test. Although the guideline single premium will equal the death benefit if the death benefit increases 6% per year, compliance with the requirements of the cash value corridor is also necessary. Under the cash value corridor, specified amounts of current insurance protection are required at all times. See notes 162-66 and the accompanying text.

²⁹² IRC § 7702(e)(2).

²⁹³ See 1983 House Report, note 4, at 149; 1984 Senate Report, note 4, at 577. This exception also applies to universal life insurance contracts under which policyholders can select either a fixed death benefit or a death benefit that includes a return of cash value component. See 1982 General Explanation, note 149, at 371-74.

²⁹⁴ See 1982 General Explanation, note 149, at 372-74 (providing an example in which the guideline single premium for a nonincreasing death benefit contract is \$17,219 and the guideline single premium for a return of cash value contract is \$40,108).

ception to the first computational rule is that life insurance companies can charge adequate premiums under return of cash value contracts. Under this exception, limited increases in the death benefit are reflected in the actuarial computations required under the statute.²⁹⁵

Two provisions limit the extent to which these increases in the death benefit are reflected in the actuarial computations. First, only increases in the death benefit that are necessary to maintain a constant amount of current insurance protection are taken into account.²⁹⁶ Second, these limited increases are only reflected for contracts that follow the level annual premium model of life insurance. This second limitation is implemented separately under the cash value accumulation test and the guideline premium test.²⁹⁷ Only the guideline level premium is allowed to reflect limited increases in the death benefit.²⁹⁸ The first computational rule continues to apply without exception to the computation of the guideline single premium. Under the cash value accumulation test, the cash value of the policy cannot, at any time, exceed the net level reserve²⁹⁹ for the benefits provided under the contract.³⁰⁰ As with the

²⁹⁵ IRC § 7702(e)(2)(A), (B).

²⁹⁶ IRC § 7702(e)(2)(A). It is possible to take advantage of this rule even if the contract provides for a pattern of future death benefit increases that differs from that produced in the return of cash value policy design. If the death benefit increases no faster than cash value, then the full amount of future death benefit increases is taken into account. IRC § 7702(e)(2)(A), (B). If the death benefits increase more rapidly than under the return of cash value design, then only the increase that occurs under the return of cash value contract is reflected in the computation of the net level reserve (described in note 299) and the guideline level premiums.

²⁹⁷ IRC § 7702(e)(2)(A), (B).

²⁹⁸ IRC § 7702(e)(2)(A).

²⁹⁹ The term "net level reserve" is not defined in § 7702. In general, the net level reserve for a contract equals the sum of the net level premiums paid, plus interest credited, reduced by the mortality charges imposed under the contract. See K. Black & H. Skipper, note 8, at 346. The size of this reserve depends on the actuarially determined net level premium for the contract. The gross level premium is the amount that the policyholder must pay annually to pay for all of the benefits under the contract. *Id.* at 341-43. The net level premium is simply the gross level premium reduced by any commissions or other loading charges. In computing this net amount, it is assumed that the policyholder will pay level annual premiums beginning at the effective date of the contract and continuing until the insured reaches at least age 95. IRC § 7702(e)(2)(B).

The legislative history does not discuss how the net level premium is computed for purposes of computing this net level reserve. To be consistent with the return of cash value limitation, the net level premium should be computed on the basis of future death benefits that increase no more rapidly than the projected increase in cash value. If the net level premium were allowed to reflect all scheduled increases in the death benefit, then the net level reserve for a contract could equal the current death benefit at all times. This would occur if the death benefit increased each year in an amount equal to the sum of (1) the last year's cash value multiplied by the assumed rate of interest; plus (2) the amount of the annual premium. Computing the net level reserve in this manner is irreconcilable with the clearly stated intent of Congress in enacting § 7702. See 1983 House Report, note 4, at 102; 1984 Senate Report, note 4, at 523. Treating this contract as life insurance also conflicts with the expected effect of IRC § 7702(e)(2)(B). See 1984 General Explanation, note 80, at 653 n.55.

guideline single premium, the tax net single premium is computed without taking into account any increase in the death benefit.

The remaining computational rules also limit the extent to which use of certain actuarial assumptions will increase the investment orientation of life insurance contracts. The second computational rule prevents a life insurance company from increasing investment orientation by establishing an early maturity date for the contract.³⁰¹ At maturity, the date on which the cash value equals the specified death benefit,³⁰² the contract no longer provides any current insurance protection.³⁰³ The sooner a contract matures, the greater the net single premium³⁰⁴ and, consequently, the greater the cash value allowed under the contract. Where the contract contains an earlier maturity date, the tax net single premium and the guideline premiums are computed on the fiction that the maturity date occurs when the insured reaches age 95.³⁰⁵ Use of this fictional maturity date reduces the tax net single premium and the guideline premiums.

Under the fourth computational rule, the endowment benefit³⁰⁶ is deemed not to exceed the smallest death benefit actually (or deemed) payable under the contract.³⁰⁷ This computational rule applies to policy designs that incorporate an endowment benefit that is unduly large relative to the death benefit. For example, consider a contract with a death benefit initially set at \$1 million, but which declines after one year to \$300,000. If the insured survives until age 95, an endowment benefit equal to the original \$1 million death benefit is paid. Without the fourth computational rule, the guideline premium and the tax net single premium would reflect the amount necessary to generate a fund sufficient to generate the \$1 million endowment benefit. The cash value of the contract during the intervening years could approximate the current death benefit, in which case the current insurance protection would be mini-

³⁰⁰ IRC § 7702(e)(2)(B). This provision was added as a counterpart under the cash value accumulation test to § 7702(e)(2)(A), which provides that limited increases in death benefits are taken into account in computing the guideline level premiums. It appears that few, if any, contracts that otherwise would not comply with the requirements of the cash value accumulation test will satisfy these requirements as a result of this provision. See 1984 General Explanation, note 80, at 653 n.55.

³⁰¹ 1984 General Explanation, note 80, at 652.

³⁰² K. Black & H. Skipper, note 8, at 61-62.

³⁰³ *Id.*

³⁰⁴ K. Black & H. Skipper, note 8, at 349.

³⁰⁵ IRC § 7702(e)(1)(B). This computational rule also deems the maturity date to occur no later than when the insured reaches age 100. *Id.*

³⁰⁶ The endowment benefit is the amount payable if the insured survives until the specified termination date of the contract. J. Belth, note 41, at 42.

³⁰⁷ IRC § 7702(e)(1)(D).

mal.³⁰⁸ The fourth computational rule restricts the endowment benefits that are reflected in the computation of the guideline premiums and the tax net single premium to the smallest death benefit provided under the policy.

The third computational rule was enacted as a technical correction to eliminate an unanticipated effect of the interaction of two other computational rules. Although Congress intended to deny life insurance status to contracts that mature prior to age 95, it was anticipated that a contract providing a limited endowment benefit at an earlier age could satisfy the requirements of § 7702.³⁰⁹ Unfortunately, under the fourth computational rule, the endowment benefit is deemed not to exceed the least amount payable as a death benefit at any time under the contract.³¹⁰ For a contract that, by its terms, terminates before the insured is 95 years old, the death benefit payable in post-termination years is zero. Thus, the endowment benefit is deemed equal to zero at all times. The tax net single premium and the guideline premium so computed would be insufficient to generate the limited endowment benefit.

The third computational rule accommodates contracts that provide a limited endowment benefit.³¹¹ Under this rule, the death benefit is deemed to continue until the deemed maturity date of the contract.³¹² Consequently, the fourth computational rule will not restrict the endowment benefit to zero. Notwithstanding the limited purpose of the third computational rule, its literal terms apply too broadly: All scheduled death benefit decreases are disregarded in computing the tax net single premium and the guideline premiums. In an extreme case, a one-year term life insurance policy is treated as a whole life policy for purposes of computing the tax net single premium and the guideline premiums. There is no justification for deeming the death benefit to continue for purposes other than allowing limited endowments, and the third computational rule should be amended to correct this problem.

³⁰⁸ The extent to which this policy design could remove the current insurance protection depends on whether it satisfies the cash value accumulation test or the guideline premium/cash value corridor test. Without the fourth computational rule, no limits apply under the cash value accumulation test. For contracts subject to the guideline premium/cash value corridor test, continued compliance with the cash value corridor requires that the ratio of the death benefit to the cash value never fall below the percentages specified in IRC § 7702(d). See notes 162-67 and the accompanying text.

³⁰⁹ See 1984 General Explanation, note 80, at 652. To illustrate the limited endowment benefit, consider a single premium life insurance contract with a death benefit of \$100,000 insuring the life of a 35-year-old. Assume further that if the insured is alive at age 65, the contract terminates and the policyholder receives \$30,000. The \$30,000 payable upon the termination of the contract is the limited endowment benefit.

³¹⁰ IRC § 7702(e)(1)(D).

³¹¹ See H.R. Rep. No. 426, 99th Cong., 1st Sess. 965 (1985), reprinted in 1986-3 C.B. (vol. 2) 965 [hereinafter 1985 House Report]; 1986 Senate Report, note 230, at 986-87.

³¹² IRC § 7702(e)(1)(C).

C. Analysis and Evaluation of the Adjustment Rules

A life insurance contract satisfies the requirements of § 7702 if the cash value (or the premiums paid) is not excessive relative to the contractual benefits, given the age of the insured. The limitations imposed on the cash value (and premiums) depend primarily on the magnitude of the death benefit provided.³¹³ Reliance on limitations based on the contractual benefits specified when the contract is issued made it necessary to devise a mechanism to cope with changes in the terms of the contract. The mechanism used to adjust the limitations to changes in the contractual terms are the adjustment rules.

1. Need for an Adjustment Rule

Unless the actuarial limitations reflect changes in the contractual terms implemented after the issuance of the contract, two problems may occur. The first problem arises where the death benefit increases after the contract is issued. In the absence of an adjustment rule, the guideline premium limitation may prove unduly restrictive.³¹⁴ If the guideline premiums are not increased, a policyholder will be unable to pay sufficient premiums to fund the benefits under the contract. In future years, the current premiums will increasingly pay for current insurance and expense charges.³¹⁵

³¹³ The guideline premium and the tax net single premium are computed with reference to all future benefits under the contract. IRC § 7702(b)(1), (c)(3)(A). In addition to the death benefit, future benefits include the endowment benefit and the charges for any qualified additional benefit. See notes 257-66 and the accompanying text. The endowment benefit reflected in the guideline premiums and the tax net single premium cannot exceed the smallest death benefit provided under the contract. IRC § 7702(e)(1)(D).

³¹⁴ This problem arises only in connection with contracts subject to the guideline premium test. For a contract subject to the cash value accumulation test, § 7702 relaxes the limitations on cash value independently of the explicit adjustment rule. Following an increase in the death benefit, the tax net single premium changes automatically to reflect the current death benefit. See IRC § 7702(b)(2)(C). Because the tax net single premium increases, the cash surrender value is also allowed to increase without violating the cash value accumulation test. IRC § 7702(b)(1). In effect, the policyholder is permitted to pay a premium sufficient to increase the contract's cash value in an amount at least equal to the tax net single premium for the additional death benefit.

For contracts complying with the guideline premium limitation, serious problems may arise. Guideline premiums are determined as of the issue date of the policy. IRC § 7702(c)(3)(C). Premiums sufficient to pay all charges for a policy with a given death benefit are inadequate for a policy with a much larger death benefit.

³¹⁵ A policyholder is allowed to increase the death benefit under a universal life insurance policy. See notes 139-41 and the accompanying text. An increase in the death benefit under the contract causes the mortality charges under the contract to increase. If the increased mortality charges exceed the current premium payments, the cash value of the policy is used to pay the mortality charges. Eventually, the cash value is depleted, and the current premiums are then used solely to pay the mortality charges. The speed at which the cash value is depleted in

In the absence of an adjustment rule, a policyholder could purchase a new life insurance contract, and thereby increase the total death benefits payable under life insurance contracts. The limitations applicable to an existing contract do not affect the new contract's limitations on either cash value or premiums paid. Similarly, premiums paid in connection with the new contract do not affect the preexisting contract's continued compliance with its guideline premium limitation. Permitting a policyholder to pay additional premiums when benefits are increased without requiring the purchase of a new contract permits a greater degree of flexibility and may reduce the policyholder's out-of-pocket costs.

A second problem may arise in the absence of an adjustment rule: The original limitations may become unduly liberal where a policyholder reduces a contract's death benefit (or other benefit). Because the initial death benefit exceeds the death benefits actually provided under the contract, the initial guideline premium (or the maximum permitted cash value) exceeds the amounts required to pay for those benefits.³¹⁶ As a result, the cash value could accumulate more rapidly, thereby permitting the policyholder to earn untaxed interest income in excess of the amount that would have been earned if only the "needed" premiums were paid.³¹⁷

this manner depends on the magnitude of the increase in the death benefit and the insured's age when the adjustment occurs.

In determining whether the premiums paid exceed the guideline premium limitation, premium payments limited to the minimum amount needed to keep the contract in effect through the end of the contract year are disregarded. IRC § 7702(f)(6). These premiums are disregarded, however, only if the contract has no cash surrender value at the end of the contract year. *Id.* This provision enables an individual who has become uninsurable to maintain insurance protection that is either unavailable or much more expensive.

³¹⁶ Both the tax net single premium and the guideline premium are the amounts required to fund the future benefits under the contract, given certain assumptions concerning the rate of interest credited, the mortality charges, and the expense charges imposed throughout the life of the contract. See notes 90-92, 147-60 and the accompanying text. If future benefits are reduced, the post-adjustment mortality charges imposed will be less than were anticipated when these computations were originally made.

This result is illustrated through consideration of a single premium contract with an initial death benefit of \$100,000 issued to a 35-year-old individual. If the mortality charges are based on the 1958 CSO Mortality Table and the expense charges equal 10% of the premiums paid plus \$3 per \$1,000 of death benefits, the guideline single premium is \$17,219. See 1982 General Explanation, note 149, at 370-71. If the death benefits were reduced immediately to \$60,000, only \$10,331 (60% of \$17,219) would be needed as the guideline single premium for the benefits remaining under the contract.

³¹⁷ Under the example discussed in note 316, the cash value corridor operates as the only constraint on the policyholder's ability to reduce the amount of current insurance protection. In effect, reductions in the death benefit could transform the guideline premium test from a test based primarily on actuarial assumptions to a test consisting solely of the cash value corridor. This result would be inconsistent with the requirement that contracts satisfy both the guideline premium limitation and the cash value corridor. It would also permit a more investment-oriented contract than is allowed under either of the existing tests. See 1983 House Report, note 4, at 147.

2. *Operation of the Adjustment Rule: Recomputed Limitations and Required Distributions*

In response to these two problems, the statute provides that “proper adjustments” are required “if there is a change in the benefits under (or in other terms of) the contract.”³¹⁸ The threshold question in examining this provision is whether an event has occurred that triggers an adjustment. Although the terms “benefits under the contract” and “other terms of the contract” are not defined in the statute, the legislative history provides several illustrations of adjustment-triggering events.

a. *Events that Trigger an Adjustment*

The determination of whether an adjustment is required depends on whether the cash value accumulation test or the guideline premium test governs the contract. For purposes of the cash value accumulation test, a change in the size of the death benefit constitutes a change in the benefits, whether resulting from application of a policyholder dividend to the purchase of a paidup addition or from some other cause.³¹⁹

The legislative history indicates that adjustments are less likely for contracts subject to the guideline premium limitation. For these contracts, an increase in the death benefit is treated generally as an increase in the benefits under the contract. Where the increase is attributable solely to the growth in cash value of the contract, however, no adjustment is made.³²⁰ In addition, an insurance-company-initiated increase in benefits under contracts subject to the guideline premium limitation will not trigger an adjustment.³²¹

³¹⁸ IRC § 7702(f)(7)(A).

³¹⁹ 1984 Senate Report, note 4, at 577. Adjustments are only made where the change in benefits was not reflected in previous computations under the contract. *Id.* For example, a policy might state that the initial death benefit is \$100,000 and that the death benefit at all times in the future will equal the sum of the current cash value plus \$100,000. Although the death benefit increases in future years, these increases were previously reflected in the computation of the guideline level premiums. See IRC § 7702(e)(2)(A); notes 292-300 and the accompanying text. No adjustment in the guideline level premium is appropriate when the increases in the death benefit actually take place.

Certain scheduled increases in benefits that were previously disregarded in computing the limitations, however, are treated as an adjustment when the increases take effect. 1983 House Report, note 4, at 149; 1984 Senate Report, note 4, at 577. All increases in the death benefit are disregarded in the computation of the guideline single premium and the tax net single premium. See notes 297-300 and the accompanying text. Consequently, an adjustment is required in computing these amounts when the death benefit actually increases.

³²⁰ 1984 Senate Report, note 4, at 577. Arguably, no adjustment is required in these circumstances because the use of the 6% rate of interest in computing the guideline single premium, rather than the 4% rate used in the tax net single premium, reflects the possibility that higher rates of interest would be credited.

³²¹ *Id.* It is unclear whether company initiated changes should never trigger adjustments for contracts subject to the guideline premium limitation. Because the payment of excess inter-

The adjustment rule trigger is not limited to changes in the basic death benefit. An adjustment is required to reflect any "change in the benefits under (or in other terms of) the contract."³²² Consequently, an increase or decrease in the endowment benefit or any qualified additional benefit also triggers an adjustment.³²³

b. Adjustments Following Increases in Benefits

(1) *The Statutory Rules:* Different rules apply to adjustments required following increases and decreases in the benefits under a life insurance contract. The adjustments required following an increase in benefits differ depending on whether the cash value accumulation test or the guideline premium limitation governs the contract in question.³²⁴ If benefits increase under a contract subject to the cash value accumulation test, the entire policy is treated as newly issued on the date of the change, and the tax net single premium is recomputed at that time.³²⁵ The requirements of the cash value accumulation test are satisfied if the post-adjustment cash value does not exceed this recomputed tax net single premium.

For contracts subject to the guideline premium test, separate guideline premiums are computed for the changed portion of the contract.³²⁶ Dur-

est (interest paid at a rate in excess of the contractually guaranteed rate) does not trigger an adjustment, no adjustment should result from a short-term company guarantee of a higher interest rate. It is arguable, however, that increases in the permanent contractually guaranteed rate of interest, or reductions in the mortality charges, should trigger an adjustment. At a minimum, where the timing and magnitude of the changes are sufficient to call into question the original contractual terms, an adjustment is appropriate.

³²² IRC § 7702(f)(7)(A).

³²³ It is unclear whether an adjustment is required when a policyholder withdraws cash from a contract under which the net amount at risk remains constant. Under such a contract, the cash withdrawal reduces both the current death benefit and the endowment benefit. An adjustment should be required unless the reduced level of benefits was previously reflected in the computations of the tax net single premiums and the guideline premiums. If the tax net single premium or the guideline premium would have been smaller if the post-withdrawal endowment benefit had been provided at all prior times, then the change was not reflected in the prior computations.

³²⁴ 1984 Senate Report, note 4, at 577.

³²⁵ *Id.*

³²⁶ *Id.* See also 1982 General Explanation, note 149, at 370-71. The separate guideline premiums reflect the current age of the insured, rather than the age of the insured at the time that the contract was issued. 1985 House Report, note 311, at 967; 1986 Senate Report, note 230 at 989. This adjustment procedure is illustrated by examining the contract discussed in note 316 which is issued to a 35-year-old individual. See 1982 General Explanation, note 149, at 371-75 (providing the basis for this example). Under this contract, the death benefit is \$100,000, the guideline single premium is \$17,219, and the guideline level premium is \$1,590. If the death benefit is increased to \$150,000 when the insured reaches age 55, then the adjustment rules require that guideline premiums be computed for a contract providing a \$50,000 death benefit issued to a 55-year-old individual. For such a \$50,000 contract, the guideline single premium is \$19,627 and the guideline level premium is \$1,970.

The guideline premiums for the additional \$50,000 death benefit for a 55-year-old insured individual may appear disproportionately large compared to the initially computed guideline

ing post-adjustment years, the guideline premiums for the original benefits and those for the increased benefits are added together to determine the post-adjustment guideline premium limitation.³²⁷

(2) *Analysis of the Adjustment Rules Applicable to Increases in Benefits:* Absent an adjustment rule, the limits on premiums payable may be inadequate to fund an increased level of benefits.³²⁸ Because a policyholder can purchase a new policy containing the additional benefits, § 7702 should accommodate the changes when they occur through a change in the terms of an existing contract. In evaluating the adjustment rules applicable to increases in benefits, an appropriate criterion is whether the additional premiums (or cash value) allowable are commensurate with the additional benefits provided under the contract.

The adjustment-caused increase in the guideline premium limitation depends on the relative magnitudes of the pre-adjustment guideline single premium and the sum of the pre-adjustment guideline level premiums. If the original guideline single premium is larger, then the adjustment-caused increase in the guideline premium limitation equals the guideline single premium for the additional benefits. If the sum of the original guideline level premiums is larger, then the adjustment produces a smaller increase in the guideline premium which, during the first post-adjustment year, is at least as large as the guideline level premium.³²⁹

Although the adjustment rules accommodate increases in future benefits in a manner that is reasonably consistent with the logic of the guideline premium test, these rules are subject to two criticisms. First, the guideline premium limitation increases even where the pre-adjustment

premiums. The difference in the guideline premiums computed at the two ages reflects the fact that the premiums paid at an earlier age will earn interest for a longer period.

³²⁷ In the example discussed in note 326, the guideline single premium for all subsequent years is the sum of the guideline single premiums for the original benefits and for the additional death benefit. Consequently, after the death benefit is increased, the guideline single premium is \$36,846. This figure is the sum of the initial guideline single premium (\$17,219) and the guideline single premium for the additional \$50,000 death benefit (\$19,627).

For post-adjustment years, the sum of the guideline level premiums equals the sum of (1) the original guideline level premium multiplied by the number of years that the contract has been in force, plus (2) the guideline level premium for the adjustment, multiplied by the number of post-adjustment years. Thus, in each post-adjustment year, the sum of the guideline level premiums increases by \$3,560. This figure is the sum of the original guideline level premium (\$1,590) and the guideline level premium for the additional benefits (\$1,970).

³²⁸ See notes 314-15 and the accompanying text. Because the guidelines premium test's limitations are determined solely with reference to the benefits specified when the contract is issued, this discussion focuses on the effect of the adjustment rules on contracts subject to the guidelines premium limitation.

³²⁹ Where the pre-adjustment sum of the guideline level premiums exceeds the original guideline single premium, the adjustment-caused increase in the guideline premium is the greater of: (1) the sum of the post-adjustment guideline level premiums for the additional benefits; and (2) the excess of (a) the guideline single premium for the additional benefits, over (b) the amount by which the sum of the original guideline level premiums exceeded the original guideline single premium.

cash value is sufficient to fund the post-adjustment future benefits. The original guideline premiums were based on assumptions concerning the rate of interest to be credited, and the mortality and expense charges to be imposed, under the contract.³³⁰ Increases in the cash value of the contract resulting from differences between the assumed and the actual level of charges imposed and rates of interest credited do not affect the guideline premiums. If these increases are sufficiently large, the cash value may exceed the amount necessary to fund the contract's future benefits.³³¹ If the cash value is too large at a time when future benefits are increased, the increase in the guideline premium limitation allowed under the adjustment rules is unwarranted.

The second criticism is that the adjustment rules do not create full parity between a policyholder who increases benefits under an existing contract and one who obtains the additional benefits under a new contract. Situations may arise where the guideline premium limitation for a single contract with increased benefits is less than the aggregate limitations for separate contracts.³³² This failure to achieve parity is not a serious shortcoming of the adjustment rules. To achieve parity, an adjustment rule would have to specify that the post-adjustment guideline premium limitation is never less than the aggregate limitation available under separate contracts. It would have been difficult, however, to design such a rule without creating new possibilities for abuse.³³³ On balance, the failure of the adjustment rules to generate the precise limitations that would result if separate contracts were acquired is less

³³⁰ See notes 147-60 and the accompanying text.

³³¹ Under the guideline premium test, the cash value is allowed to increase without limitation unless the cash value corridor would be violated. For any given death benefit, the maximum cash value permitted without violating the cash value corridor exceeds the amount reasonably required to pay for the benefits provided under the policy. See note 168 and the accompanying text.

³³² Disparities arise in two sets of circumstances. First, disparities arise if both (1) the guideline single premium for the additional benefits exceeds the sum of the guideline level premiums for those benefits, and (2) the original guideline single premium is less than the sum of the original guideline level premiums. If these conditions are present, the post-adjustment guideline premium limitation for the single contract is less than the sum of the guideline premium limitations for the two separate contracts (one of which contains the original benefits, and the other contract contains the additional benefits).

Second, disparities arise between contracts in which additional benefits are obtained as an adjustment and contracts where the additional benefits are obtained in a separate new policy subject to the cash value accumulation test. In this situation, as well, the adjustment rules permit payment of a lesser amount of premiums than is permitted under the separate policies.

³³³ Under a parity rule, the guideline premium limitation would increase by an amount equal to the full guideline single premium for the additional death benefit. This rule might inflate the guideline premium limitation if the policyholder alternately decreased and then increased future benefits. Although a decrease in benefits causes a reduction in the guideline premium limitation, this reduction occurs over a number of years if the sum of the original guideline level premiums exceeds the original guideline single premium. See note 342 and the accompanying text (discussing the slow squeeze-out when benefits are reduced). The conse-

serious than the problems that alternative rules would create. Because a policyholder can achieve parity through the purchase of separate contracts, concerns regarding potential abuses are properly given great weight.

c. Adjustments Following Reductions in Benefits

(1) *The Statutory Rules:* Adjustments made following a reduction in future benefits require a two step analysis. First, the remaining future benefits under the contract are examined to determine if the contract continues to satisfy the applicable test under § 7702(a). For contracts subject to the cash value accumulation test, the cash value of the contract is compared to the tax net single premium computed with respect to the contract's remaining future benefits. If the cash value is less than the tax net single premium, no further steps are required under the adjustment rules. If the cash value exceeds the tax net single premium, however, a cash distribution to the policyholder is required.³³⁴ This required distribution equals the amount necessary to bring the contract into compliance with the cash value accumulation test, that is, the excess of the contract's cash value over the tax net single premium for the remaining benefits under the contract.³³⁵

A similar, but more complex, procedure applies for contracts subject to the guideline premium limitation test. Separate guideline premiums are computed for the eliminated future benefits.³³⁶ For post-adjustment years, the guideline premiums equal the initial guideline premiums less the guideline premiums computed for the eliminated benefits.³³⁷ No fur-

quence of decreasing and then increasing the future benefits by identical amounts would be to increase substantially the guideline premium limitation.

A policyholder could obtain the same increase in the aggregate guideline premium limitation by reducing the death benefit under an existing contract, and simultaneously acquiring a new contract with a death benefit equal to the death benefit eliminated from the first contract. The reduction in benefits under the original contract, however, may cause the premiums paid to exceed the new guideline premium limitation. In this case, a distribution of cash to the policyholder is required. Under IRC § 7702(f)(7)(B), a portion of this distribution is included in gross income. See notes 380-91 and the accompanying text. Under a parity rule, the permissible level of premium payments is increased without requiring the inclusion of any amount in gross income under IRC § 7702(f)(7)(B).

³³⁴ 1984 Senate Report, note 4, at 577-78; 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989. Whether the amount distributed to the policyholder as a result of an adjustment is treated as a tax-free return of the policyholder's basis in the insurance policy or as a taxable distribution of the interest credited to the cash value is determined under § 7702(f)(7)(B). See notes 380-91 and the accompanying text.

³³⁵ 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989.

³³⁶ 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989. See also notes 326-27 and the accompanying text (discussing the similar calculation required when benefits are increased).

³³⁷ For post-adjustment years, the sum of the guideline level premiums equals (1) the original guideline level premiums multiplied by the number of years that the contract has been in

ther action is required if the total premiums paid do not exceed the post-adjustment guideline premium limitation and if the cash value does not exceed the maximum amount permitted under the cash value corridor.³³⁸ A distribution of cash to the policyholder is required if either of these conditions is not satisfied.³³⁹

The distribution required when a contract does not satisfy both conditions is the minimum amount necessary to bring the policy back into compliance with the guideline premium test. This minimum amount equals the greater of (1) the amount by which the premiums paid under the contract exceed the post-adjustment guideline premium limitation,³⁴⁰ and (2) the excess of the contract's cash value over the post-adjustment cash value corridor.³⁴¹

The size of the required distribution varies greatly where it is computed with reference to the post-adjustment guideline premium limitation. If the post-adjustment guideline single premium exceeds the post-adjustment sum of the guideline level premiums, then the required distribution is the amount necessary to reduce the premiums paid to the post-adjustment guideline single premium. If the post-adjustment guideline single premium is less than the post-adjustment sum of the guideline level premiums, then the required distribution in the first post-adjustment year is only the amount necessary to reduce the premiums paid to an amount

force, reduced by (2) the guideline level premium for the eliminated benefit multiplied by the number of post-adjustment years. To illustrate, if the death benefit is reduced to \$50,000 under the contract discussed in note 316, during each post-adjustment year, the sum of the guideline level premiums will decline by \$380. This is the amount by which the guideline level premium for the eliminated benefit (\$1,970) exceeds the original guideline level premium (\$1,590).

The post-adjustment guideline single premium equals the original guideline single premium reduced by the guideline single premium for the eliminated benefit. In the contract discussed above, this computation will result in a negative guideline single premium because the original guideline single premium (\$17,219) is less than the guideline single premium for the eliminated benefit (\$19,627).

The legislative history does not discuss the ramifications of a negative guideline premium limitation. Continued compliance with the guideline premium/cash value corridor test requires that the premiums paid not exceed the guideline premium limitation. It appears that a distribution of cash to the policyholder cannot reduce the premiums paid below zero. See IRC § 7702(f)(1). If sufficient cash is distributed to reduce the premiums paid to zero, a contract with a negative guideline premium limitation should not automatically be viewed as violating the guideline premium limitation. For other purposes, allowing guideline premiums to become negative prevents the artificial inflation of the guideline premium limitation by alternative increases and decreases in the death benefit.

³³⁸ 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989.

³³⁹ 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989.

³⁴⁰ The term "premiums paid" is generally defined as the actual premiums paid, less all amounts returned to the policyholder that were not included in the policyholder's income. IRC § 7702(f)(1)(A). The cash distributed to the policyholder that is includable in gross income under § 7702(f)(7)(B), however, also reduces the premiums paid for purposes of § 7702. 1985 House Report, note 311, at 967-68; 1986 Senate Report, note 230, at 989.

³⁴¹ 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989.

equal to the post-adjustment sum of the guideline level premiums.³⁴² In these circumstances, the annual decline in the sum of the guideline level premiums will require additional distributions in subsequent years. The slow pace of required distributions may occur even where the policyholder paid only a single premium equal to the guideline single premium on the date the policy was issued.

(2) *Analysis of Adjustments Following Reductions in Benefits:* Where benefits are reduced, the adjustment rules work adequately if the implicit constraints on investment orientation of life insurance contracts are maintained. Following a reduction in benefits, the limitations established when the contract was issued may prove unduly generous. Hindsight may show that a policyholder accumulated excessive cash values in the contract, and thereby earned excessive investment income.³⁴³ To determine whether the adjustment rules prevent a policyholder from enjoying an inappropriate increase in the contract's investment orientation, it is necessary to consider the following questions: (1) Is the post-adjustment cash value of the policy (or the amount of premiums paid under the policy) excessive? (2) If so, what sanctions are properly imposed where excessive accumulations (or premium payments) occur?

Before answering these questions, standards are needed to assess whether excessive cash value has accumulated or whether the policyholder has paid excessive premiums. The conceptual basis underlying both the cash value accumulation test and the guideline premium/cash value corridor test is that the cash value (or the premiums) cannot exceed the amount necessary to pay for the future benefits specified under the contract.³⁴⁴ The contract is not treated as life insurance if, given the actuarial assumptions used in computing the applicable limitation, more cash value is accumulated (or more premiums are paid) than is required to pay for the future benefits.³⁴⁵

³⁴² In the example discussed in note 326, assume that the death benefit is reduced from \$100,000 to \$60,000 when the insured reaches age 45. Before the death benefit was reduced, the guideline single premium was \$17,219. The sum of the original guideline level premiums for the 10 years that the policy was in effect equals \$15,900 (10 times \$1,590).

After the death benefit is reduced, the adjustment rules require the computation of separate guideline premiums for the eliminated benefits. Reflecting the fact that the insured is 45 years old, the guideline single premium computed with respect to the \$40,000 death benefit is \$12,042 and the guideline level premium for this benefit is \$1,136.

Immediately following the adjustment, the guideline single premium is \$5,177 (\$17,219 less \$12,042) and the sum of the guideline level premiums is \$14,764 (\$15,900 less \$1,136). If the premiums paid exceed \$14,764, then a distribution of cash to the policyholder is required.

³⁴³ The presence of less restrictive limitations will not necessarily lead to more investment-oriented uses of life insurance in all cases. Frequently, the premiums paid are less than the guideline premium limitation, and the cash values of the contracts are less than the tax net single premium.

³⁴⁴ See notes 87-89 and 143-49 and the accompanying text.

³⁴⁵ IRC § 7702(g).

Following a reduction in future benefits, it may become apparent that a life insurance contract was used in a more investment-oriented fashion than is consistent with the conceptual basis underlying the limitations. A contract subject to the cash value accumulation test was overly investment oriented if the accumulated cash value exceeded the maximum cash value that would have been accumulated if the tax net single premium had, at all times, reflected the reduced benefits actually provided under the contract. Similarly, a contract subject to the guideline premium limitation was used in an overly investment-oriented fashion if the premiums paid exceeded a hypothetical guideline premium limitation computed with respect to the benefits actually provided under the contract. If the cash value (or the premiums paid) exceeds these more restrictive hypothetical limitations, the contract has an excessive investment component.³⁴⁶

Where the cash value (or premium payments) is excessive, it is necessary to decide what sanctions are properly imposed. One possibility would be to terminate the status of the policy as a life insurance contract. If this were done, all interest income previously credited would be taxable to the policyholder at that time.³⁴⁷ In form, this approach is consistent with the consequences of exceeding the limitations on a prospective basis. Both the cash value accumulation test and the guideline premium limitation, however, are intended to operate as in *terrorem* rules. To avoid disqualification, life insurance companies can adopt safeguards that prevent inadvertent violations of the limits and thereby assure that their contracts remain in compliance on a prospective basis.³⁴⁸

Disqualification of a policy is less appropriate if noncompliance with the limitations is only determined in hindsight. Benefits are often re-

³⁴⁶ The cash value (or the premiums paid) is excessive if it exceeds the amount needed to fund the actual benefits under the contract. This measure of investment orientation appears most appropriate in light of the general limitations contained in § 7702. It is possible to devise different measures of investment orientation. For example, one alternative measure focuses on the extent to which insurance charges reduce the gross investment return under a policy. Under this measure, a contract that experiences a reduction in benefits is not overly investment oriented for periods prior to the reduction since the annual net investment return (i.e., the interest credited reduced by the payment of the cost of current insurance protection) did not exceed the annual net investment return on policies that provided a nondeclining pattern of death benefits.

³⁴⁷ See IRC § 7702(g).

³⁴⁸ See Comer, *TEFRA's Conversion of Universal Life Into Flexible Premium Life Insurance Contract*, 3 J.L. & Com. 325, 339 (1983). To prevent inadvertent disqualification of contracts subject to the cash value accumulation test, a company could incorporate into its contracts a provision that automatically increases the death benefit whenever the contract would otherwise violate the cash value limitation. Similarly, for contracts subject to the guideline premium limitation, the life insurance company could refuse to accept premiums in excess of the guideline premium limitation. Alternatively, the company could incorporate a provision into its contracts increasing the death benefit whenever a premium payment otherwise would result in the violation of the guideline premium limitation.

duced for reasons other than a desire to maximize the investment use of life insurance. For example, a policyholder's financial condition may change or family events may affect the policyholder's need for life insurance. Terminating life insurance status in these changed circumstances may be overkill.

Moreover, disqualification of a policy following certain reductions in benefits would give inappropriate weight to formalistic differences. The same insurance and investment benefits are obtainable either through the ownership of several small contracts or a single large contract. The consequences of reducing the benefits would differ, however, depending on whether there was a single contract or multiple contracts in existence. In the multiple contract situation, the policyholder could terminate some of the separate contracts and thereby reduce the aggregate benefits provided. In this instance, the only amount includable in gross income is the excess of the cash value of the terminated contracts over the premiums paid for them.³⁴⁹ The interest credited under the terminated contracts used to pay for the costs of current insurance protection, as well as all interest credited under the nonterminated contracts, is not includable in the policyholder's gross income.³⁵⁰ In comparison, if the reduction in benefits under a single contract resulted in the disqualification of the contract, the entire amount of interest credited under the policy is includable in gross income.³⁵¹

Although it is inappropriate to disqualify a contract following a reduction in benefits, remedial steps are justified. A reduction in benefits may demonstrate that more cash was accumulated (and more investment income was earned) than would have been accumulated (or earned) if the contract specified the actual pattern of benefits. The failure to treat the excess cash value as a taxable investment fund prior to the adjustment was based on the mistaken premise that the entire cash value, and the income generated therefrom, would pay for the future benefits under the contract. When that premise is proven false, any arguable tax policy justification for permitting that entire fund to receive favorable tax treatment ceases to exist. At that time, the economic benefits derived from the mistaken assumptions should be eliminated, which can be accomplished in two remedial steps.

The first remedial step would mandate the distribution to the policyholder of amounts not needed to pay for the remaining future benefits. Such a distribution would limit the remaining cash value (and, indirectly,

³⁴⁹ IRC § 72(e).

³⁵⁰ See notes 59-63 and the accompanying text. Alternatively, a policyholder could exchange an existing contract for a new contract that provides a smaller death benefit. Under § 1035, the amount includable in income is limited to the lesser of the boot received or the gain realized on the exchange.

³⁵¹ IRC § 7702(g).

the tax favored investment income to be earned in the future) to the amount needed to pay for the remaining benefits. This is accomplished under the existing adjustment rules for contracts subject to the cash value accumulation test.³⁵² For these contracts, the excessive accumulation of cash value is the excess of the cash value over the tax net single premium for the remaining benefits.³⁵³ Given the applicable actuarial assumptions,³⁵⁴ this amount is not needed to pay for future benefits. The existing adjustment rules require the distribution of this excess amount of cash value to the policyholder.³⁵⁵

It is more difficult to determine the appropriate distribution for contracts subject to the guideline premium limitation which, unlike the cash value accumulation test, does not attempt to compare the cash value to the amount currently needed to pay for the future contractual benefits.³⁵⁶ Rather, the guideline premium limitation represents an estimate of the premiums needed to create a fund sufficient to pay for the future benefits. Most significantly, these estimates are computed when the contract is issued, and are not adjusted to reflect actual experience under the contract. In comparison, the tax net single premium constantly compares the accumulated cash value to the estimated future benefit costs, and thereby takes into account actual experience under the contract.

Because the guideline premiums do not reflect actual experience under the contract, there are two reasons why the post-adjustment excessive accumulation cannot be computed solely by reference to the premiums paid. First, the timing of the premium payments may significantly impact the accumulation of cash value under a policy,³⁵⁷ but is only a mi-

³⁵² See notes 334-35 and the accompanying text (describing the required distribution for contracts subject to the cash value accumulation test).

³⁵³ To the extent that further reductions in benefits scheduled to occur in subsequent years are disregarded under § 7702(e)(1)(C), the tax net single premium is overstated. See notes 311-12 and the accompanying text. In these circumstances, the excessive accumulation of cash value exceeds the amount described in the text.

³⁵⁴ See IRC § 7702(b)(2).

³⁵⁵ See notes 334-35 and the accompanying text.

³⁵⁶ Although contracts subject to the guideline premium limitation must also comply with the cash value corridor (IRC § 7702(a)(2)(B)), the cash value corridor does not measure the amount needed to pay for the remaining benefits. See notes 167-69 and the accompanying text. Rather, it operates as a backup to the guideline premium limitation, which is the primary mechanism that limits the investment orientation of life insurance contracts. See Chiechi & Adney, note 163, at 341.

³⁵⁷ Assume, for example, two separate contracts under both of which the guideline single premium is \$10,000 and the guideline level premium is \$2,000. Under the first contract, a \$10,000 premium is paid on day 1. Because the guideline premium limitation for this contract is \$10,000 for the first five years, the policyholder cannot pay any additional premiums until year 6. Under the second contract, a \$2,000 premium is paid in year 1. An additional premium of \$8,000 is paid at the end of year 5. Although the premiums paid are the same under the two contracts, the cash value and the amount of interest credited to the first contract will be substantially greater than the cash value and the interest credited to the second contract.

nor factor in determining compliance with the guideline premium limitation. Second, differences between the actuarial assumptions and the actual experience under the contract do not affect the guideline premiums.³⁵⁸ These differences will affect contracts subject to the guideline premium limitation only when the cash value is sufficiently large, relative to the current death benefit, that the contract would not satisfy the requirements of the cash value corridor.³⁵⁹

It is impossible to determine on an a priori basis the overall net effect of the uncertain timing of the premium payments and the differences between the actuarial assumptions and the experience under the contract. It is likely that a contract's cash value would increase more rapidly than it would if interest had been credited at the assumed rate, and the assumed mortality and expense charges had been imposed. It is possible, however, that differences between the actual pattern of premium payments and the patterns assumed in computing the guideline premiums (i.e., a single premium and a schedule of level annual premiums) could reduce the actual cash value to a level below the maximum assumed levels.

To evaluate whether the distributions required to comply with the guideline premium/cash value corridor test are appropriate, consideration of these uncertain effects is necessary. As discussed above, the required distribution equals the excess of the premiums paid over the post-adjustment guideline premium limitation.³⁶⁰ Whether this amount fairly approximates the excessive cash value of the policy depends in large part on the timing of both the premium payments and the adjustment.³⁶¹

The required distribution is likely to approximate the excessive cash value if only a single premium was paid when the policy was issued and the post-adjustment guideline premium limitation equals the post-adjustment guideline single premium.³⁶² In many other situations, the exces-

³⁵⁸ The principal actuarial assumptions concern the rate of interest credited under the policy, the cost of insurance protection, and the expense charges. See notes 152-60 and the accompanying text. If interest is credited at rates in the range experienced during the latter part of the 1970's and the 1980's, the rates of interest credited are likely to exceed the rates used in computing the guideline premiums. Similarly, because the mortality and expense charges specified in the contract are the maximum rates that can be charged, the actual charges will be no greater than assumed and may be substantially less.

³⁵⁹ See IRC § 7702(a)(2)(B), (d).

³⁶⁰ See notes 338-42 and the accompanying text.

³⁶¹ A distribution equal to the excess of the cash value over the tax net single premium for the remaining benefits would closely approximate the excess cash value. If such a distribution were required, it would become necessary to determine how the distribution would reduce the premiums paid for purposes of establishing future compliance with the guideline premium limitation.

³⁶² The guideline single premium for the eliminated benefit reflects the attained age of the insured. 1985 House Report, note 311, at 967; 1986 Senate Report, note 230, at 989. As a result, the adjustment-caused reduction in the guideline single premium reflects the assumed rate of interest and charges for the period from the issuance of the policy to the date of the

sive cash value will greatly exceed the required distribution. This will occur frequently if the post-adjustment sum of the guideline level premiums exceeds the post-adjustment guideline single premium.³⁶³ A reduction in benefits can affect the sum of the guideline level premiums in either of two ways. First, the reduction may cause the post-adjustment sum of the guideline level premiums to increase more slowly than it would have increased in the absence of the adjustment.³⁶⁴ Second, the post-adjustment sum of the guideline level premiums may decline in absolute terms.³⁶⁵

No post-adjustment distribution is required where the post-adjustment sum of the guideline level premiums continues to increase,³⁶⁶ and the policy may retain any excessive cash value. Where the post-adjustment sum of the guideline level premiums declines, it will do so slowly, over a period of years. Consequently, distributions are required during that period. The delayed distribution of the excessive cash value provides an unwarranted benefit to the policyholder.

It can be concluded from this that the required distribution rules applicable to contracts governed by the guideline premium test work imperfectly in many situations. Frequently, the distributions take place too slowly. At worst, no distribution is required even where the cash value of the contract exceeds the amount required to fund the future benefits.

An alternative to the existing required distribution rule could focus on the hypothetical cash value that would exist if the actual pattern of benefits provided under the contract were known when the policy was issued.³⁶⁷ Under this alternative, the required distribution would equal the excess of the actual cash value over this hypothetical amount.³⁶⁸ Use of

adjustment. Any difference between the required distribution and the excessive cash accumulation is attributable to differences between actuarial assumptions and experience under the contract.

³⁶³ The relative sizes of the guideline level premium and the guideline single premium depend on the age of the insured at the time that the contract is issued. The longer the contract remains in effect, the greater the likelihood that the sum of the guideline level premiums will exceed the guideline single premium.

³⁶⁴ The sum of the guideline level premiums will increase if the original guideline level premium exceeds the guideline level premium computed for the eliminated benefits. See note 337. In these circumstances, the guideline premium limitation increases each year following the adjustment.

³⁶⁵ See note 337.

³⁶⁶ This conclusion assumes that following the adjustment the policy complies with the cash value corridor.

³⁶⁷ Legislation would be needed to implement this alternative. Although the adjustment rule enacted as part of the 1984 Act contained a broad grant of regulatory authority, this was eliminated in the 1986 technical corrections to § 7702(f)(7). See 1985 House Report, note 311, at 966-67; 1986 Senate Report, note 230, at 988.

³⁶⁸ This hypothetical cash value could be computed using either of two assumptions concerning the timing and pattern of premium payments. The first assumption is that the maximum permissible amount of premiums were paid, or the maximum permissible cash value was

this hypothetical set of facts would also determine whether compliance with the post-adjustment guideline premium limitation has occurred. The post-adjustment premiums paid could not exceed the amounts allowable under the hypothetical guideline premium limitation.

3. *Characterization of Distributions Required Following an Adjustment*

Where a cash distribution to the policyholder is required following a reduction in benefits, it is necessary to determine whether the distribution is characterized as taxable gain in whole or in part, or as a tax-free return of the policyholder's investment. Prior to the enactment of § 7702, the Code contained different, and inconsistent, rules used to characterize the receipt of cash in a transaction that does not involve the complete disposition of the policyholder's ownership rights with respect to the contract.

a. *Alternative Characterization Rules*

The first characterization rule applies to distributions under life insurance contracts that were received other than "as an annuity." Under the stacking rules generally applicable to life insurance contracts (other than modified endowment contracts), distributions are treated first as a non-taxable return of the premiums paid under the policy,³⁶⁹ in effect an "income out last" characterization rule. Expressly included within the scope of this provision were "amounts in the nature of dividends and similar distributions,"³⁷⁰ and amounts paid on the surrender, redemption, or maturity of the contract.³⁷¹ The second method of taxing distri-

accumulated, and, consequently, the policyholder paid either a premium equal to the guideline single premium or a premium sufficient to produce cash value equal to the tax net single premium. The investment return is based on rates of return and charges actually experienced under the policy. Under the second set of assumptions, the investment return is based on the cash value that would accumulate under the actual pattern of premium payments made under the policy. To the extent that any premium payments would have caused the policy to violate the guideline premium limitations, the premium payments are suspended. Any suspended premium payment is credited to the contract only if, and when, an increase in the applicable limitation occurs that would allow the payment of additional premiums.

³⁶⁹ See notes 50-51 and the accompanying text. If any amount is paid under a life insurance contract as an annuity, each payment is divided into taxable and nontaxable portions by application of an exclusion ratio. See IRC § 72(b), (e)(5)(C). Under this procedure, a taxpayer is treated as receiving her investment in the contract over the period that the annuity payments are made. Prior to the 1986 Act, if the annuitant lived for a longer or shorter time than her life expectancy, the total amount excluded from income would differ from the investment in contract. For taxpayers whose annuity starting dates are after December 31, 1986, however, the amount excluded from gross income is limited to the taxpayer's investment in the contract. 1986 Act § 1122(h)(2)(B). If annuity payments cease due to the death of the annuitant before the full amount invested in the contract is received, a deduction is allowed for the unrecovered amount for the annuitant's last taxable year. IRC § 72(b)(3).

³⁷⁰ IRC § 72(e)(1), as in effect prior to amendment by TEFRA.

³⁷¹ IRC § 72(e)(5)(C).

butions applies to cash received incident to the exchange of one life insurance contract for another. If, as part of this exchange, the policyholder only receives another life insurance contract, no gain is recognized.³⁷² If any property other than a like-kind contract is also received, however, gain is recognized under the rules governing the receipt of boot in like-kind exchanges.³⁷³ Under these rules, the amount includable in gross income is the lesser of the value of the unlike-kind property received or the total amount of gain realized on the exchange.³⁷⁴ This is a limited "income out first" method of taxation.

A third characterization rule would treat a distribution as income to the extent of any excessive investment income earned prior to the reduction in benefits. Any additional distribution would be characterized as a tax-free return of the policyholder's investment.

b. Statutory Characterization Rules

In fashioning a rule governing the receipt of cash incident to a reduction in benefits, it was possible to adopt any of the three alternative characterization rules. In 1984, an "income out first" rule modeled after the like-kind exchange provisions of § 1035 was enacted.³⁷⁵ This rule treated any reduction in future benefits as an exchange of the existing contract for a new contract.³⁷⁶ As a result, any cash that the policyholder received was treated as boot and was taxed as ordinary income.³⁷⁷

Critics challenged this rule as overly broad because it appeared to apply to any distribution paid upon surrender of paid-up additions, as a policy loan, or as policyholder dividends.³⁷⁸ Given Congress' unwillingness to change the stacking rules applicable to life insurance contracts under § 72(e), this broad income out first rule was arguably inappropriate.³⁷⁹

³⁷² IRC § 1035(a).

³⁷³ IRC §§ 1035(c)(1), 1031(b); see notes 57-58 and the accompanying text.

³⁷⁴ IRC § 1031(b); Reg. § 1.1031(b)-1. This characterization rule is similar to the stacking rule applicable to distributions from annuity contracts. See IRC § 72(e)(1).

³⁷⁵ IRC § 7702 (f)(7)(B) (before amendment in 1986).

³⁷⁶ *Id.*

³⁷⁷ 1983 House Report, note 4, at 149; 1984 Senate Report, note 4, at 578. The legislative history indicates that § 7702(f)(7)(B) was intended to apply specifically to changes from a "return of cash value" contract to a fixed death benefit contract even where the current death benefit was not reduced. There is an indication, however, that this provision was not intended to indirectly repeal the application of § 72(e) to life insurance contracts. See 1984 General Explanation, note 80, at 654.

³⁷⁸ See Harman, Adney & McKeever, *The Taxation of Life Insurance Companies and Their Products—The Effects of the Tax Reform Act of 1986—Part II*, 41 *J. Am. Soc'y C.L.U.* 38, 38-39 (May 1987); Fitzgerald, *Will Annuity Withdrawal Rules Be Applied to Life Insurance?* 125 *Tr. & Est.* 35 (June 1986).

³⁷⁹ In 1983, the Treasury Department proposed extending the income out first stacking rules to life insurance contracts. 1983 Hearings, note 39, at 38. This proposal was not included

In response to this criticism, Congress enacted a new, more elaborate, and much narrower rule governing lump sum distributions incident to an adjustment.³⁸⁰ In general, a lump-sum payment is subject to the "income out first" rule only where two conditions are satisfied.³⁸¹ First, the adjustment must occur during the 15 year period beginning on the issue date of the contract.³⁸² Second, a cash distribution to the policyholder must be required as a result of the reduction in benefits.³⁸³ In addition, where these conditions are satisfied, the full amount distributed to the policyholder is not necessarily subject to the income out first rule, for the maximum amount includable in income is limited to the recapture ceiling applicable to the contract at the time of the adjustment.³⁸⁴

The magnitude of the recapture ceiling depends on when the reduction in benefits occurs.³⁸⁵ In addition, for five years after the issuance of the

in the 1983 proposal of Representatives Stark and Moore concerning the tax treatment of life insurance products. *Id.* at 498, 502-3.

³⁸⁰ IRC § 7702(f)(7)(B)-(E).

³⁸¹ IRC § 7702(f)(7)(B). In addition to limiting the situations that are subject to § 7702(f)(7)(B), the 1986 Act also specifies that § 72 (other than subsection (e)(5)) applies to the cash distribution. For contracts not eligible for the life insurance stacking rules of § 72(e)(5), a distribution is characterized according to an income out first rule. Under § 72, the income is limited to the excess of the cash value of the policy over the investment in the contract at that time. IRC § 72(e)(3). If the distribution were characterized under § 1035, a larger portion could be treated as income because the fair market value of the policy may exceed its cash value. See Rev. Rul. 54-264, 1954-2 C.B. 57.

Because all distributions from modified endowment contracts are subject to the income out first distribution rules of § 72, § 7702(f)(7)(B) will not affect the taxation of adjustment caused distributions from these contracts.

³⁸² IRC § 7702(f)(7)(B)(ii). The statute does not define the term "issue date of the contract." Use of a literal definition of this term invites attempts to avoid the income characterization rule. For example, consider a contract issued in 1985. If the benefits are increased tenfold in the year 2001, any subsequent distribution is not subject to the income out first rule of § 7702(f)(7)(B). It is possible to interpret the phrase "issue date of the contract" as the date that any substantial increase in benefits is made effective. The legislative history recognized that making substantial changes to an existing contract may be tantamount to the issuance of a new contract. See Staff of Joint Committee on Taxation, *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation 107* (Comm. Print 1987). For this reason it indicated that in appropriate circumstances, a modified contract should be treated as a new contract. *Id.*

³⁸³ IRC § 7702(f)(7)(B)(iii).

³⁸⁴ IRC § 7702(f)(7)(B). To illustrate, consider a contract in which the investment in the contract is \$700 and the contract's cash value is \$1,000. If, as a result of a reduction in the death benefit, \$500 is distributed to the policyholder, the portion of this distribution subject to the income out first rule is limited to the recapture ceiling. Thus, if the recapture ceiling is \$150, the policyholder includes that amount in gross income, with the remaining \$350 treated as a nontaxable return of premiums. Furthermore, if the recapture ceiling exceeds the income in the contract, the amount included in gross income is limited to the lesser amount. Thus, if the recapture ceiling is \$350, the policyholder includes only \$300 in gross income. IRC §§ 72(e)(2)(B), 7702(f)(7)(B).

³⁸⁵ Different recapture ceilings apply for distributions made during the first five years that the contract is in effect, (§ 7702(f)(7)(C)), and for distributions made after the contract has been in effect for at least 5, but less than 15 years. IRC § 7702(f)(7)(D).

contract, the recapture ceiling is computed differently for contracts subject to the cash value accumulation test than it is for contracts subject to the guideline premium/cash value corridor test. For contracts subject to the cash value accumulation test, the recapture ceiling is the minimum cash distribution that is sufficient to bring the contract back into compliance with that test (i.e., the excess of the cash value over the post-adjustment tax net single premium).³⁸⁶ For contracts subject to the guideline premium limitation test, the recapture ceiling is the greater of: (1) the amount by which the total premiums paid prior to the adjustment exceeds the post-adjustment guideline premium limit; and (2) the amount by which the cash value of the policy exceeds the maximum amount of cash permitted after the adjustment under the cash value corridor.³⁸⁷

During years 5 through 15, for all contracts the recapture ceiling is simply the excess of the cash value over the maximum amount of cash permitted after the adjustment under the cash value corridor.³⁸⁸ Thus, for contracts subject to the cash value accumulation test, the recapture ceiling may be zero even where the cash value exceeds the tax net single premium for the remaining benefits.

The statute also contains an anti-abuse rule designed to catch taxpayers who withdraw cash before benefits under the contract are reduced.³⁸⁹ A distribution made in anticipation of a reduction in future benefits is treated as if made as a result of the subsequent reduction in the future benefits under the contract.³⁹⁰ For this purpose, any distribution occurring within the two-year period prior to the reduction in benefits is presumed made in anticipation of the reduction in benefits.³⁹¹

c. Tax Policy Analysis of Characterization Rules

The revised characterization rules applicable to cash distributed incident to a reduction in benefits incorporates three distinct allocation rules which correspond to the three models of taxing distributions discussed above: (1) income out first, (2) income out last, and (3) a hybrid allocation. In evaluating these allocation rules, the justification for using each of the three models in the context of an adjustment will be discussed.

(1) *The First Five Years: Income Out First:* During the first five years following issuance of a policy, distributions required to assure post-adjustment compliance with the applicable limitation are subject to an in-

³⁸⁶ IRC § 7702(f)(7)(C)(i).

³⁸⁷ IRC § 7702(f)(7)(C)(ii).

³⁸⁸ IRC § 7702(f)(7)(D).

³⁸⁹ See 1985 House Report, note 311, at 968; 1986 Senate Report, note 230, at 989.

³⁹⁰ IRC § 7702(f)(7)(E).

³⁹¹ *Id.*

come out first rule.³⁹² Because the required distributions under the two tests may differ, the amount included in gross income depends on the test that governs the contract in question.³⁹³

Although this characterization rule is inconsistent with the ordering rule that has historically applied to distributions from life insurance contracts,³⁹⁴ it can be defended on several grounds. As discussed above in connection with the tax policy analysis of the stacking rules, it is arguable that all distributions received under a life insurance policy should be subject to an income out first rule.³⁹⁵ Additional support is needed, however, to demonstrate that this rule should apply to cash received incident to an adjustment, notwithstanding the fact that the traditional income out last ordering rule is retained for other distributions.³⁹⁶

Additional support for the use of the income out first rule for adjustment caused distributions is found in the conceptual underpinnings of the limitations contained in § 7702. The tax net single premium and the guideline premiums establish the maximum degree of investment orientation for a contract treated as life insurance for tax purposes. These limitations are computed on the assumption that future benefits will not change.³⁹⁷ Use of these prospectively computed limitations may have allowed the policyholder to accumulate cash value, or pay premiums, in excess of the amounts needed to establish a sufficient fund to pay for the actual benefits provided under the contract. Similarly, the investment return attributable to any unneeded cash value (or unneeded premiums) is not necessary to provide the actual benefits under the contract.

The generation of such unneeded investment income is inconsistent with the purpose of the overall limitations. Under both the cash value accumulation test and the guideline premium limitation, the maximum permissible investment return is limited to the amount needed to pay for the contractual benefits.³⁹⁸ It is appropriate to treat any investment income earned in excess of these amounts as if it is derived from an investment other than a life insurance contract.³⁹⁹ In computational terms,

³⁹² See notes 385-87 and the accompanying text (discussing the application of § 7702(f)(7)(B) during the contract's first 5 years).

³⁹³ See notes 334-42 and the accompanying text (describing the adjustments required under each test).

³⁹⁴ See notes 50-51 and the accompanying text.

³⁹⁵ See notes 229-33 and the accompanying text.

³⁹⁶ The criticism of the original income out first rule of § 7702(f)(7)(B) was based, in large part, on the inconsistency between the rules governing distributions generally and the rules applicable to adjustments. See notes 378-79.

³⁹⁷ See IRC § 7702(e)(1)(C), discussed in notes 309-12 and the accompanying text.

³⁹⁸ See notes 90-92 and 145-49 and the accompanying text.

³⁹⁹ Even if this amount were included in gross income when the reduction in benefits occurs, the policyholder still has enjoyed the benefit resulting from deferral of the payment of tax on the excessive investment income. If any excessive investment income were subject to a surtax reflecting the value of the deferral, this economic benefit would be reduced or eliminated. In

the excess investment income is the excess of the actual investment income earned over the hypothetical amount that would have been earned under the policy if the tax net single premiums (or the guideline premiums) had been computed with reference to the actual pattern and levels of benefits provided under the contract.⁴⁰⁰

Measured against this standard, the "income out first" rule applicable during the first five years appears severe because, in many instances, the dollar amount distributed will exceed the excessive investment income.⁴⁰¹ This severity, however, is more apparent than real. The full amount subject to the income out first rule is not necessarily included in gross income. Rather, the portion includable in gross income is limited to the amount "allocable to income on the contract" under § 72,⁴⁰² which, for this purpose, is the excess of the predistribution cash value over the policyholder's unrecovered basis in the contract.⁴⁰³

Limiting the amount includable in gross income to the excess of the policy's cash value over its basis is likely to cause the taxable amount to understate the interest credited under the contract. In computing the amount allocable to income, the interest actually credited is offset by the amounts charged as commissions and for current insurance protec-

other situations, a penalty is imposed in lieu of the actual value of deferral. See IRC § 72(o)(2), (q), (t), (v). Investment income determined to be excessive at the time that an adjustment occurs should be subject to a comparable penalty.

⁴⁰⁰ If additional cash value is allowed due to the assumption that the death benefits would not decline, the amount of current insurance protection provided under the contract declines. As a result, the mortality charges under the policy also decline. Because the mortality charges are reduced, the additional return attributable to the accumulation of the additional cash value exceeds the nominal rate of interest credited.

⁴⁰¹ The relative magnitudes of the excessive investment income and the required distribution depends on many variables, including: (1) the age of the insured, (2) timing of the premium payments, (3) the rate of interest credited, and (4) the level of expense and mortality charges actually imposed under the contract compared to the charges assumed in computing the tax net single premium and the guideline premiums.

The relationship between the excessive investment return and the required distribution is illustrated through consideration of the contract discussed in note 316, which provided an initial death benefit of \$100,000 for a 35-year-old individual. Under the cash value accumulation test, the maximum initial cash value is \$27,074. Four years later, the maximum permitted cash value is \$30,826. If the contract's death benefit is reduced at that time to \$60,000, the maximum permitted cash value declines to \$18,496. If the contract's cash value is equal to the pre-adjustment maximum, then a distribution of \$12,330 (i.e., \$30,826 — \$18,496) is required to remain in compliance with the cash value accumulation test.

If the initial tax net single premium had been based upon the actual pattern of future benefits, the maximum initial cash value would have been limited to \$16,732. Consequently, the use of a nondeclining pattern of benefits in computing the tax net single premiums allows the policyholder to generate an extra \$10,342 in cash value at age 35 (\$27,072 — \$16,732). It is likely that the investment return credited on this amount over a 4-year period is significantly less than the \$12,330 that is subject to the income out first rule.

⁴⁰² IRC § 72(e)(2)(B)(i). Section 72 (other than subsection (e)(5)) applies to the portion of any distribution incident to a reduction in benefits that satisfies the conditions of § 7702(f)(7)(B).

⁴⁰³ See IRC § 72(e)(3), (6).

tion.⁴⁰⁴ The combined effect of these offsets is to reduce greatly, if not to eliminate, the portion of an adjustment caused distribution that is includable in gross income.⁴⁰⁵

At best, the amount includable in income following an adjustment during the first five years crudely estimates the excessive investment income earned under the contract; the only way it will fairly approximate the excessive investment income is by the random offsetting of multiple errors. In many instances, income will be significantly understated. Given the justification for requiring that the entire amount of excessive investment income be included in gross income, the rationale for the existing rule is unclear. A more sensible provision would focus more directly on the excessive investment income earned under the contract, and would require that this amount be included in gross income.⁴⁰⁶

(2) *Years Five to Fifteen: A Hybrid Approach:* For policies that have been in effect for between 5 and 15 years, a different characterization rule applies to distributions required following a reduction in benefits. Again, a portion of the distribution is characterized according to an income out first rule. The maximum amount subject to this rule (the recapture ceiling) is the excess of the pre-adjustment cash value over the maximum post-adjustment cash value that is permitted without violating the cash value corridor.⁴⁰⁷ Although compliance with the cash value corridor is only required for contracts subject to the guideline premium limitation,

⁴⁰⁴ See notes 59-63 and the accompanying text (discussing the understatement of income under the § 72(e) withdrawal rules).

⁴⁰⁵ This effect is illustrated using the example discussed in note 401. In this example, the policyholder accumulated excessive cash value of \$10,342 at age 35. As a result of the reduction in the death benefit that occurred in year 4, a distribution of \$12,330 was required. If a commission (or other expense charge) equal to 10% of the premium had been charged, the amount includable in income would be reduced to \$739. This represents an annual rate of return of less than 2% of the excessive cash value.

Under certain conditions, the amount includable in gross income may exceed the interest allocable to excessive accumulations of cash value. This may occur where the increase in the cash value reflects higher rates of interest credited, and lower charges imposed, under the policy than are assumed in computing the tax net single premium and the guideline premiums.

⁴⁰⁶ An adjustment rule requiring that the excessive investment income be included in gross income could impose substantial administrative burdens. Two factors tend to limit the burden of this computation. First, the adjustment rules only apply to contracts issued after December 31, 1984. Second, computations would only be required in connection with contracts having a substantial pre-adjustment cash value relative to the post-adjustment death benefit. For such contracts, precise computations would be required. The availability of detailed computerized records would also help.

⁴⁰⁷ IRC § 7702(f)(7)(D). The cash value corridor is defined in terms of the death benefit and cash surrender value of the contract. IRC § 7702(d); notes 162-68 and the accompanying text. For purposes of § 7702(f)(7)(D), the death benefit is limited to the amount payable on the death of the primary insured. Although term insurance for family members is a qualified additional benefit (§ 7702(f)(5)(iii)), only the charges for qualified additional benefits are treated as future benefits under the contract. IRC § 7702(f)(5)(B). As a result the death benefit payable under the family term coverage is not treated as a death benefit for purposes of the cash value corridor. See IRC § 7702(f)(3), (4).

this recapture ceiling also applies to contracts subject to the cash value accumulation test. In almost all instances, the required distribution will exceed this recapture ceiling.⁴⁰⁸ Consequently, except in rare circumstances, the portion of an adjustment-caused distribution subject to the income out first rule equals the lesser of the recapture ceiling and the income on the contract.⁴⁰⁹

As with the income out first rule applicable during the first five years, a proper evaluation of this rule compares the amount included in gross income to the excessive investment income earned under the contract.⁴¹⁰ The relative magnitude of these amounts depends on the interaction of numerous factors,⁴¹¹ which makes it impossible to draw absolute conclusions. Three general observations are, nonetheless, possible.

Observation 1: As was true with respect to adjustments taking place during the first five years, the amount includable in gross income cannot exceed the amount allocable to income on the contract during years 5 through 15. Again, the amount allocable to income on the contract understates the amount of interest credited under the policy.⁴¹² As before, this understatement occurs because the interest credited is offset by the aggregate charges for commissions and current insurance protection.

The disparity between the interest credited and the amount allocable to income increases over time because charges for current insurance protection are imposed every year. It is unclear, however, how the disparity between the amount allocable to income and the excessive investment income earned will change over time. The amount allocable to income is

⁴⁰⁸ Under § 7702(f)(7)(B), if the required distribution is less than the recapture ceiling, the full amount of the distribution is subject to the income out first rule. In most situations, however, only a portion of the required distribution will be subject to the characterization rule. For contracts governed by the cash value accumulation test, the required distribution equals the excess of the cash value over the tax net single premium for the remaining benefits. See notes 334-35 and the accompanying text. For a given death benefit, the cash value allowed under the cash value corridor generally exceeds the tax net single premium. See note 168 and the accompanying text. The tax net single premium exceeds this cash value only where substantial qualified additional benefits are provided under the contract. These qualified additional benefits affect the tax net single premium, but do not affect the cash value corridor. Consequently, the required distribution will exceed the recapture ceiling unless substantial qualified additional benefits are provided for in the contract.

For contracts governed by the guideline premium limitation, the adjustment-caused required distribution is the greater of: (1) the amount by which the total premiums paid prior to the adjustment exceed the post-adjustment guideline premium limit; and (2) the amount by which the policy's cash value exceeds the maximum amount of cash permitted after the adjustment under the cash value corridor. Because the required distribution is the greater of two amounts, one of which is the recapture ceiling, for contracts in effect for between 5 and 15 years, the required distribution is never less than the recapture ceiling.

⁴⁰⁹ See notes 401-403 and the accompanying text.

⁴¹⁰ See notes 397-400 and the accompanying text.

⁴¹¹ See note 401 (discussing the magnitude of excessive investment income during the first five years that a policy is in effect).

⁴¹² See notes 404-405 and the accompanying text.

depressed during the initial years to the extent that the cash surrender value is reduced to reflect the substantial first year commissions.⁴¹³ In subsequent years, the amount allocable to income will increase² by a larger proportion of the interest credited. Whether the amount allocable to income will overstate or understate the excessive investment income earned under the contract is determinable only on a case-by-case analysis.⁴¹⁴

Observation 2: The recapture ceiling applicable during the fifth through the fifteenth years provides a cushion that may cause the amount includable in gross income to understate the excessive investment income. Consider, for example, a contract insuring the life of an individual 45 years of age for \$100,000. The tax net single premium is slightly more than \$37,000.⁴¹⁵ Even if the death benefit were reduced to \$80,000, the recapture ceiling would be zero,⁴¹⁶ ensuring that no portion of any required distribution, including excessive investment income credited, would be subject to the income out first rule. Where the death benefit is reduced more substantially, the recapture ceiling is greater than zero. The relative sizes of the recapture ceiling resulting from such a substantial reduction in death benefits and the excessive investment income is not determinable on an a priori basis.

Taxpayers seeking untaxed investment income can avoid application of the income out first rule if they take maximum advantage of the cushion incorporated in the recapture ceiling. If the post-adjustment death benefit equals the cash value of the contract multiplied by the applicable percentage specified under the cash value corridor,⁴¹⁷ the recapture ceiling is zero. The entire required distribution is treated as nontaxable return of

⁴¹³ See K. Black and H. Skipper, note 8, at 527 (first year commissions constitute at least 50% of the premium on a level annual premium policy; subsequent commissions are much smaller).

⁴¹⁴ In the example discussed in note 401, the tax net single premium of \$27,074 was computed on the assumption that the death benefit would not decline. If the tax net single premium had been based on the assumption that the death benefit is reduced after 10 years to \$60,000, the maximum initial cash value would have been \$17,447. Use of the nondeclining pattern of death benefits in computing the tax net single premium permits an extra \$9,627 of cash value when the contract is issued.

Assuming that interest is credited at a 4% rate, over 10 years the extra cash value earns \$4,623 of interest. In this case, the amount allocable to income equals \$10,132, which is the excess of: (1) the contract's cash value (which, at the end of 10 years, will equal \$37,206) over (2) total premiums paid (\$27,074). Of course, if the premiums paid included loading charges not reflected in the initial cash value, § 72(e) reduces this amount accordingly.

⁴¹⁵ The exact figure is \$37,206. This calculation is computed using a 4% assumed rate of interest and mortality charges equal to the amounts specified in the 1958 Commissioners' Standard Ordinary mortality table. No qualified additional benefits are provided under the contract.

⁴¹⁶ A contract will satisfy the requirements of the cash value corridor when the insured is 45 years of age if the death benefit is at least 215% of the cash value. See IRC § 7702(d).

⁴¹⁷ See IRC § 7702(d)(2).

capital, notwithstanding the presence of substantial excessive investment income.

Observation 3: Flaws in the rules governing the required distributions for certain contracts subject to the guideline premium limitation may cause the amount includable in income to understate the excessive investment income earned in the contract.⁴¹⁸ No post-adjustment distribution is required where the post-adjustment sum of the guideline level premiums continues to increase.⁴¹⁹ Even where the post-adjustment sum of the guideline level premiums declines, the required distributions are made over a period of years.

The amount includable in gross income due to the reduction in benefits cannot exceed the required distribution. Unless a distribution is required, the policyholder need not include any amount in gross income.⁴²⁰ This may occur even where excessive investment income is earned under the contract. If distributions are required, the inclusion in gross income occurs only as the distributions take place. The delayed inclusion in gross income of the excessive investment income provides an unwarranted benefit to the policyholder.

In conclusion, the income out first characterization rule applicable during years 5 through 15 is seriously flawed. As was true with respect to the earlier years, the flaws are subtle. As a result of the interplay of the statutory provisions, the amount subject to the income out first rule is often significantly less than the excessive investment income earned under the contract. For all contracts, the cushion incorporated into the recapture ceiling effectively negates the income out first rule even when the death benefits are significantly reduced. In addition, for contracts subject to the guideline premium test, the method used to compute the required distribution further limits the scope of the income out first rule.

(3) *The Golden Years—Distributions After Year Fifteen: Income Out Last:* For policies that are in effect for more than 15 years, the traditional “income out last” characterization rule applies to distributions required as a result of a reduction in benefits.⁴²¹ Under this approach, all distributions are treated as a tax-free return of basis until the policyholder re-

⁴¹⁸ See notes 364-66 and the accompanying text.

⁴¹⁹ *Id.* This conclusion assumes that the policy complies with the cash value corridor following the adjustment. No post-adjustment distribution may be required during the first 5 years if the guideline single premium less than 5 times as large as the guideline level premium. See IRC § 7702(c). These conditions are satisfied primarily when the policy is issued to a relatively elderly individual. See K. Black & H. Skipper, note 8, at 314-15.

⁴²⁰ IRC § 7702(f)(7)(B).

⁴²¹ Section 7702(f)(7)(B) applies only to changes occurring during the 15 year period beginning on the issue date of the contract. IRC § 7702(f)(7)(B)(ii). As a result, § 72(e)(5) applies to distributions received under a policy after the 15-year period expires. In general, the distribution is treated first as a tax-free return of premiums paid under the contract. See note 50.

ceives an amount equal to the premiums paid in connection with the contract.⁴²²

The retention of the income out last rule for contracts in their golden years is difficult to justify on a tax policy basis. The longer the period that a life insurance contract remains in force, the greater is the excessive investment income earned. Admittedly, difficulties exist in distinguishing the excessive investment income from the unneeded premium payments. This difficulty, however, does not justify subjecting all distributions to an income out last rule after 15 years. The same difficulty exists during the prior periods. In addition, as the amount of excessive investment income increases, the likelihood of mischaracterization of a distribution should decrease.

One possible rationale for the golden years rule is that it is easily administered and applies to situations in which the likelihood of abuse is remote. This justification would be premised on the assertion that any adjustment occurring after 15 years would have a minor effect on the guideline premiums and the tax net single premiums in the earlier years. In other words, 15 years is asserted to be beyond the planning horizon of abuse minded taxpayers. This assertion does not withstand critical analysis.

It is an actuarial truism that temporally distant events have a much smaller effect on present values than events occurring in the near future.⁴²³ This truism, however, does not prove that adjustments occurring after 15 years would have an insignificant effect on the tax net single premiums and the guideline premiums. The magnitude of these items will depend on the interaction of numerous variables.⁴²⁴ The significance of adjustments occurring after 15 years is illustrated through consideration of a contract issued to a 35-year-old individual with a \$100,000 initial death benefit. The initial tax net single premium for this contract is approximately \$27,000.⁴²⁵ In comparison, the initial tax net single premium would be approximately \$18,100 if the tax net single premium had reflected a reduction in the death benefit to \$60,000 occurring after 15 years. The effect of the year 15 reduction in the death benefit on the tax net single premium cannot be dismissed as insubstantial. In fact, the tax net single premium for the actual pattern of death benefits is much closer

⁴²² IRC § 72(e)(5).

⁴²³ See K. Black & H. Skipper, note 8, at 325-27.

⁴²⁴ The most significant factors in these calculations are the age of the insured, the amount of current insurance protection, the charges imposed for the insurance protection at different ages, and the rate of interest assumed in the computations. The 15-year period tends to reduce the effect of any adjustment on the tax net single premiums and the guideline premiums. This effect is offset, if not eliminated, as a result of the higher amounts charged for insurance protection at older ages.

⁴²⁵ See note 401.

to the tax net single premium for a contract with a \$60,000 death benefit than it is to a \$100,000 death benefit.⁴²⁶

If a contract's permissible cash value increases as a result of the assumption that the death benefits would not decline, the minimum amount of current insurance protection provided under the contract declines. As a result, mortality charges under the contract also decline. Because the mortality charges are reduced, the additional return attributable to the accumulation of the additional cash value exceeds the nominal rate of interest credited.

4. Adjustment Rules: Conclusions

The adjustment rules are intended to perform two important functions: (1) to allow a degree of flexibility to be built into all policies, and (2) to assure that undue tax benefits are not realized as a result of the existence of high benefits in effect on the issuance date of the contract. While these rules perform adequately in accommodating increases in benefits under both the cash value accumulation test and the guideline premium/cash value corridor test, they deal poorly with reductions in benefits.

A reduction in benefits may indicate that unneeded cash value was allowed to accumulate under the contract, and that excessive investment income was earned. The provisions determining the size of required distributions apply in an uneven manner. For contracts subject to the cash value accumulation test, the required distribution may fairly approximate the excess accumulation permitted to build up under the contract, but for those subject to the guideline premium/cash value corridor test, the required distribution is very likely to understate the excessive accumulation.

The provisions governing characterization of the required distribution are more seriously flawed. These characterization rules appear to tax adjustment-caused distributions on an income out first basis. Notwithstanding the appearances, excessive investment income is received in many instances as a tax-free return of basis. In addition, where the contract has been in effect for more than 15 years, no pretense is made of applying an income out first characterization rule.

The flaws contained in the adjustment rules create an ineffective deterrent against strategies designed to inflate the tax net single premium (or the guideline premiums) during the initial years of a contract. For exam-

⁴²⁶ The tax net single premium for an otherwise identical policy with a \$60,000 death benefit is \$16,244. A similar relationship exists for the guideline single premiums: The guideline single premium is \$15,916 if the death benefit is \$100,000. It is only \$9,550, however, for a policy with a \$60,000 death benefit, and \$11,145 for a policy with a \$100,000 death benefit that is reduced to \$60,000 after 15 years.

ple, the addition of qualified additional benefits (such as family term coverage) to a contract causes the tax net single premium (and the guideline premium) to increase. Similarly, using a return of cash value policy design causes the guideline level premium to increase.⁴²⁷ The policyholder could eliminate these qualified additional benefits (or change to a level death benefit policy design) at a time when, under the adjustment rules, no amount would be included in the taxpayer's income. As is evident, the adjustment rules invite, rather than discourage, creative strategies that inflate the investment orientation of a life insurance contract.

III. CONCLUSIONS AND RECOMMENDATIONS FOR LEGISLATIVE CHANGE

A. Conclusions Concerning Existing Law

Section 7702 represents a codification of existing practices, rather than a systematic overhaul of the tax treatment of cash value life insurance. Under § 7702, only contracts with insufficient insurance features are treated as taxable investments. If a life insurance contract satisfies the statutory definition of life insurance contained in § 7702, its owner enjoys several tax benefits. Most significantly, the investment income credited to the contract is not taxed currently and may never be taxed. Because a life insurance company can deduct the amounts credited to its policyholders, this investment income entirely escapes taxation.

No convincing justification exists for taxing life insurance investments more favorably than other financial investments. Supporters of the current preferential tax treatment argue that it encourages the provision of insurance protection and savings for retirement. A critical analysis demonstrates that the existing tax provisions do not advance these policy goals in a rational manner.

The tax treatment of life insurance creates an irrational set of incentives to encourage taxpayers to provide increased insurance protection. First, the tax benefits provided are inversely related to a taxpayer's insurance needs. Paradoxically, the greatest tax benefits accrue to wealthy taxpayers who purchase substantial single premium contracts, whereas no benefit is made available to those with much greater insurance needs.⁴²⁸ Second, and more significantly, the current tax provisions perversely encourage taxpayers to reduce their insurance protection. A taxpayer who switches from term to cash value life insurance generally decreases the amount of insurance protection.⁴²⁹ Similarly, a first-time purchaser of life insurance obtains a modest amount of insurance protec-

⁴²⁷ See IRC § 7702(e)(2)(A); notes 292-98 and the accompanying text.

⁴²⁸ See notes 197-200 and the accompanying text.

⁴²⁹ See note 196 and the accompanying text.

tion in the form of cash value life insurance, rather than a larger amount of term insurance coverage. Thus, any shift in taxpayer behavior in response to the tax incentives frustrates, rather than advances, the goal of increased insurance protection.

Use of cash value life insurance as a source of post-retirement income does not justify special tax treatment. A life insurance contract's cash value does not differ materially from many forms of taxable savings. Unlike qualified pension plans, IRAs, and deferred annuities, cash value life insurance is not subject to any qualification requirements and limitations on contributions.⁴³⁰ Moreover, the tax treatment of pre-retirement distributions from the other investment vehicles, including the imposition of early withdrawal penalties, demonstrates that any arguable justification for preferential tax treatment terminates when cash is received.⁴³¹ Preretirement distributions from life insurance contracts (other than modified endowment contracts) are not presumptively taxable.

Notwithstanding the lack of tax policy justification, the enactment of § 7702 was premised on retaining preferential tax treatment for life insurance investments. Congress recognized, however, that limitations on investment orientation are needed. In general terms, § 7702 establishes a maximum permissible degree of investment orientation that is equivalent to that existing under a single premium contract. Much of the extraordinary complexity of § 7702 results from attempts to prevent life insurers from using actuarial techniques to increase investment orientation beyond that allowed under the single premium contract design.

The explicit statutory restrictions contained in § 7702 on the choice of actuarial assumptions are quite lenient, in the case of the interest rate assumptions, and, following the enactment of the Technical Corrections Act of 1988, are somewhat vague in the case of the assumed levels of mortality and expense charges.⁴³² Use of inappropriate assumptions may reduce the insurance component of a life insurance contract, contrary to the intent of § 7702.

Effective adjustment rules are also needed to prevent taxpayers from avoiding § 7702's implicit limitations on investment orientation. Both the cash value accumulation test and the guideline premium limitation are computed prospectively with reference to the contract's specified future benefits. A contract that overstates the benefits may accumulate ex-

⁴³⁰ The qualification requirements and restrictions applicable to qualified plans, IRAs, and deferred annuities are discussed in notes 201-13 and the accompanying text.

⁴³¹ See notes 230-33 and the accompanying text.

⁴³² Until regulations are issued, actuarial assumptions concerning mortality charges must be both "reasonable" and not materially different from the charges expected to be imposed. 1988 Technical Corrections Act § 5011(a), (c)(2). In applying similar restrictions to the assumptions concerning expense charges, the company's experience is used to determine if the charges are reasonably expected to be paid. IRC § 7702(c)(3)(B)(ii).

cessive cash value, thereby allowing the policyholder to earn excessive untaxed investment income.

Well-designed adjustment rules would eliminate any unjustified tax benefits. An adjustment occurs when contractual benefits are changed.⁴³³ When a benefit is eliminated, the adjustment rules contained in § 7702 may compel a cash distribution to the policyholder. Moreover, § 7702 characterizes certain distributions required incident to an adjustment first as income, rather than as a nontaxable return of basis. Unfortunately, these adjustment rules work poorly. Particularly for contracts subject to the guideline premium limitation, the required distribution often understates the excessive cash value accumulated. In addition, many well advised policyholders can avoid the application of income out first stacking rules. Only the unwary will get caught.

B. Recommendations for Legislative Change

In the absence of any convincing policy justification for special treatment, the investment income credited to cash value life insurance contracts should be taxed currently. It is unlikely that Congress would find such a sweeping reform acceptable because the preferential tax treatment of cash value life insurance is based more on politics than on tax policy analysis.⁴³⁴ Even if preferential treatment of life insurance remains sacrosanct, two sets of lesser reforms deserve consideration.

1. Reform of Predeath Distributions

The first set of reforms would alter the taxation of predeath distributions from life insurance contracts in the following manner: (1) Policyholders would include predeath distributions in gross income to the extent that the predistribution cash value exceeds the taxpayer's unrecovered investment; (2) policy loans would be treated as a predeath distribution for these purposes; and (3) amounts included in income as a result of this rule would be subject to an penalty tax comparable to that imposed on premature withdrawals from IRAs, pension plans, deferred annuities, and modified endowment contracts.

The appropriateness of the suggested changes is illustrated by considering a taxpayer who pays \$10,000 to purchase a life insurance contract. Investment income credited both pays for the cost of insurance protection provided and increases the contract's cash value to \$11,000. Finally, the taxpayer withdraws \$1,000 from the contract, thereby reducing the

⁴³³ The events treated as adjustments are discussed in notes 318-27, 334-42 and the accompanying text.

⁴³⁴ See Hilder & Murrey, *Life Insurers Battle "Inside Buildup" Plank of Reagan's Tax Plan*, *Wall St. J.*, June 17, 1985, at 1.

cash value to \$10,000. How should the Code characterize this predeath distribution? Because the predistribution cash value exceeds the taxpayer's unrecovered investment,⁴³⁵ gross income should include the full amount received. The \$1,000 withdrawn clearly satisfies the general requirements for including an item in gross income: The increase in the contract's cash value represents an undeniable accession to wealth which, when distributed to the policyholder, is clearly realized and over which the taxpayer has complete dominion.⁴³⁶ Moreover, the ability to receive predeath distributions on a tax-free basis may encourage policyholders to use life insurance investments for purposes unrelated to the societal goals that justified the preferential tax treatment.⁴³⁷

Taxing distributions on the suggested income out first basis is subject to two tax policy criticisms. First, some have claimed that taxpayers will not purchase cash value life insurance unless they could withdraw their investment without tax consequences.⁴³⁸ This purported disincentive has not proved compelling in connection with other tax preferred investments: Congress revised the preretirement distribution rules applicable to annuities in 1982,⁴³⁹ and, in 1986, Congress modified the taxation of preretirement distributions from IRAs and qualified pension plans.⁴⁴⁰ Similarly, concerns about marketability of cash value life insurance do not justify retaining basis recovery first distribution rules.

Second, it is arguable that a pro rata allocation rule, such as applies to distributions from pension contracts, is preferable to an income out first rule. The pro rata allocation rule represents the balance struck by Congress between two competing concerns: (1) that pension plan and IRA assets remain invested until retirement, and (2) that taxpayers be en-

⁴³⁵ One measure of the total increase in the taxpayer's net worth is the excess of the cash value over the taxpayer's investment in the contract. It is arguable that this amount should be increased to reflect the interest credited that was offset against the mortality and loading charges in the computing the cash value. See notes 59-62 and the accompanying text. Increasing the taxable gain by the amount of investment income applied for these purposes is somewhat inconsistent with the social policy goal of encouraging the provision of insurance protection.

⁴³⁶ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

⁴³⁷ See 1986 General Explanation, note 203, at 721 (discussing the reasons for modifying the treatment of preretirement distributions from qualified pension plans).

⁴³⁸ See 1983 Hearings, note 39, at 259-60 (statement of Mutual Companies Executive Committee), 523 (statement of Asst. Secretary Chapoton).

⁴³⁹ Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 265(a), 96 Stat. 324, 546 (codified as IRC § 72(e)(2)-(3)). Prior to this change, all amounts received under an annuity contract were treated first as a tax-free return of basis. Preretirement distributions from annuity contracts are now included in income to the extent that the contract's cash value exceeds the policyholder's investment in the contract.

⁴⁴⁰ IRC § 72(e)(8). The portion of the distribution from a qualified pension plan or an IRA treated as a tax-free return of capital is determined by multiplying the amount received by the ratio of the participant's basis to the participant's account balance. The remainder is included in the participant's gross income. *Id.*

couraged to participate in these retirement income programs.⁴⁴¹ Given the weak basis for preferential treatment, and the presence of nondiscrimination rules designed to expand the coverage of pension plans, a different balance should be struck in connection with cash value life insurance.

For purposes of the proposed predeath distribution rules, a loan should be treated in the same manner as other distributions. Increasingly, Congress has characterized loans secured by tax favored investments as taxable distributions rather than as loans.⁴⁴² Traditionally, the receipt of loan proceeds is not taxable because the borrower's obligation to pay interest and repay the principal offsets the receipt of cash.⁴⁴³ Loans secured by tax preferred financial assets, however, are properly distinguishable from borrowing secured by property if one examines the entire series of transactions, beginning with the purchase of the tax preferred asset and ending with the loan. The rationale for not taxing income credited to the tax preferred asset when it is earned is that the investment represents additional net savings set aside for purposes that Congress deems worthy. If a taxpayer obtains a loan linked to a tax preferred asset, no net additional savings have taken place. Without additional savings, there is no justification for not taxing the investment income credited. Consequently, the tax benefits previously enjoyed should be recaptured.

⁴⁴¹ See Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. Pa. L. Rev. 851, 892-93 (1987).

A pro rata allocation also applies to amounts received in connection with installment sales of property. See IRC § 453. The installment sales provisions respond to concerns about subjecting a seller of property to a tax that exceeds the cash received at the time of the sale. Such liquidity concerns do not apply to distributions from a life insurance contract because only the amount received is included in gross income. Moreover, for many sellers of property the pro rata allocation permitted under the installment method does not apply to the entire sales proceeds. A taxpayer who reports income from the sale of property on the installment method must recognize all recapture income in the year of sale. IRC § 453(i). In addition, an interest charge is imposed on the deferred tax liability for certain property sales. IRC § 453A.

⁴⁴² Loans from (or secured by) nonqualified deferred annuities or IRAs are treated as taxable distributions. IRC §§ 72(e)(4)(A), 408(e)(3)-(4). See also IRC § 453A(d). A more complex statutory provision applies to loans from qualified pension plans. Although pension loans are generally treated as distributions, § 72(p) respects the loan form if the terms of the loan require level amortization over a period that, in most instances, cannot exceed 5 years. IRC § 72(p)(2)(B) and (C). Even if these conditions are satisfied, loans are treated as distributions to the extent that the cumulative amounts borrowed exceed certain specified limits. IRC § 72(p)(2)(A). In attempting to identify bona fide loans, this provision necessarily imposes substantial administrative burdens on the plan administrators.

⁴⁴³ See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983); *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952). For a discussion of the arguments rejected in *Woodsam Associates*, see Lurie, *Mortgagor's Gain on Mortgaging Property for More Than Cost Without Personal Liability (Contentions of Taxpayer's Counsel in a Pending Case)*, 6 Tax L. Rev. 319 (1951).

Finally, an additional tax should apply to amounts includable in gross income on account of predeath distributions. Preretirement distributions from qualified pension plans, IRAs, and nonqualified deferred annuities are subject to an additional tax of 10%.⁴⁴⁴ Congress recognized that these additional taxes both discourage nonretirement use of the retirement savings vehicles and recapture the benefit of tax deferral that is inappropriately received.⁴⁴⁵ The same rationale justifies the imposition of an additional tax on distributions from life insurance contracts.⁴⁴⁶

2. *Reform of the Statutory Definition*

The second set of reforms would revise and restructure the statutory definition of life insurance to achieve two goals: First, the permissible degree of investment orientation would be reduced to achieve a more sensible balance between investment and insurance protection. Second, the statutory design would be simplified to make § 7702 more comprehensible and to reduce the potential for abuse.

The single premium contract should not serve as the limiting model of acceptable life insurance design because it permits an excessive degree of investment orientation. Under most single premium contracts, the untaxed investment income far exceeds the cost of the insurance protection provided.⁴⁴⁷ Assuming that preferential treatment is retained to encourage people to obtain insurance protection, the subsidy thereby provided is clearly disproportionate to the societal benefit produced.⁴⁴⁸

Several alternatives would generate a more appropriate balance between investment and insurance protection. Precise targeting of the tax incentive would result if the exclusion from gross income were limited to the interest income actually applied to pay the cost of term insurance protection. To allow a limited degree of prefunding, the exclusion from

⁴⁴⁴ IRC § 72(q), (t).

⁴⁴⁵ See 1986 General Explanation, note 203, at 713-14.

⁴⁴⁶ The penalty tax does not apply to distributions from qualified pension plans, IRAs, and nonqualified deferred annuities made: after the taxpayer attains age 59 1/2 (IRC § 72 (q)(2)(A) and (t)(2)(A)(i)); after the death of the primary beneficiary (IRC § 72(q)(2)(B) and (t)(2)(A)(ii)); after the taxpayer becomes disabled (IRC § 72(q)(2)(C) and (t)(2)(A)(iii)); or in certain other situations. Although a penalty tax applicable to distributions from life insurance contracts should contain similar exceptions, the penalty tax should apply to postretirement distributions because a life insurance contract's cash value is indistinguishable from many other taxable financial assets that can be used for retirement savings. See notes 201-13 and the accompanying text. If it is determined that cash value life insurance serves a distinct role as a source of retirement savings, however, the penalty tax should also exempt distributions prior to retirement.

⁴⁴⁷ See notes 239-44 and the accompanying text.

⁴⁴⁸ The possible use of cash value life insurance as a source of retirement savings does not justify the use of a more investment-oriented model. Unlike nonqualified deferred annuities, § 101 exempts the untaxed investment income accumulated in a life insurance contract if it is not distributed prior to the death of the insured.

gross income could extend to a specified additional amount of investment income.⁴⁴⁹ Because this approach would focus exclusively on events occurring during the taxable year, § 7702 could be greatly simplified: The limitations on actuarial assumptions, the computational rules, and the adjustment rules could be eliminated.

The major problem with this approach is political. Life insurance agents and companies would argue that it would make marketing extremely difficult because a prospective purchaser could not be told that all investment income earned would be exempt from taxation. In fact, a portion of the amounts credited under many contract designs currently marketed would be taxable under this proposal.⁴⁵⁰ The fact that this approach would apply so broadly demonstrates that undue tax subsidies are granted currently, rather than representing a flaw in this proposal.

An alternative approach would revise § 7702's concept of the maximum investment-oriented policy design. For example, § 7702 could replace the current single-premium model with a model based on the level-premium contract. The relative magnitude of the actual mortality charges and investment income earned are roughly comparable under level premium contracts, although the precise relationship depends on many factors. For example, in the level premium contract illustrated in Table 1, the mortality charges exceed the interest credited during the first five years. In most later years, however, the interest credited is approximately 50% greater than the mortality charges. One should note that this illustration is premised on the use of a 4% rate of interest; if higher rates were used, the investment orientation would increase.⁴⁵¹

The principal advantage of this approach is that it would have a more limited effect on the marketing of cash value life insurance because more contract designs would remain nontaxable. One notable disadvantage is that many of the actuarial complexities of § 7702 would still be needed. A degree of simplification would result if a single test replaced the cash value accumulation test and the guideline premium test.⁴⁵² Additional simplification would result if the actuarial based limitations were re-

⁴⁴⁹ For example, an additional exclusion from gross income of a specified dollar amount could be allowed. Alternatively, the exclusion could equal a fixed percentage of the mortality charges actually imposed.

⁴⁵⁰ For example, under the level premium policy illustrated in Appendix Table 1, interest credited (at a 4% rate) exceeds the mortality charges after the fifth contract year. This excess would be taxable unless the exclusion from gross income exceeded the level of mortality charges imposed.

⁴⁵¹ The relationship between mortality charges and investment income earned depends, in part, on the age of the insured when the contract is issued. For example, under a level-premium contract issued to a 55-year-old the mortality charges significantly exceed the interest credited (at a 4% rate) for many years. If an 8% rate were used, however, the investment income credited would significantly exceed the mortality charges after the fifth contract year.

⁴⁵² The questionable justification for two separate tests is discussed in notes 250-54 and the accompanying text.

placed with a single statutory table specifying, for different ages, the minimum death benefit to cash value ratio.⁴⁵³

⁴⁵³ The ratios specified in the table would reflect actuarial assumptions concerning interest rates, and mortality and expense charges. Use of a single set of actuarial assumptions would limit the flexibility currently allowed to adjust actuarial assumptions to reflect differences in the health of insured individuals. For example, higher mortality charges are imposed for individuals classified as substandard insurance risks. The seriousness of this problem depends on the general limitation on investment orientation. If the single premium model reflected in § 7702 is retained, or if interest is credited at rates significantly in excess of 4%, many substandard risk contracts could be marketed without difficulty. If a level-premium model were adopted, and if interest were credited at very low rates, then certain substandard contracts would terminate without cash value prior to age 95.

APPENDIX
TABLE 1
LEVEL PREMIUM CASH VALUE CONTRACT

<u>Age</u>	<u>Premium</u>	<u>Post- Premium Cash Value</u>	<u>Cost of Current Insurance Protection</u>	<u>Interest Earned</u>	<u>Closing Cash Value</u>
35	1,279	1,279	208	47	1,117
36	1,279	2,396	219	91	2,269
37	1,279	3,547	231	137	3,453
38	1,279	4,732	246	184	4,670
39	1,279	5,949	262	233	5,919
40	1,279	7,198	280	282	7,200
41	1,279	8,478	301	333	8,510
42	1,279	9,789	321	385	9,853
43	1,279	11,131	344	438	11,226
44	1,279	12,504	367	493	12,631
45	1,279	13,909	392	549	14,066
46	1,279	15,344	417	605	15,533
47	1,279	16,812	443	664	17,033
48	1,279	18,312	469	723	18,566
49	1,279	19,844	498	784	20,130
50	1,279	21,409	527	846	21,727
51	1,279	23,006	562	909	23,353
52	1,279	24,632	600	973	25,005
53	1,279	26,283	642	1,038	26,680
54	1,279	27,958	689	1,105	28,374
55	1,279	29,653	737	1,171	30,088
56	1,279	31,366	787	1,239	31,819
57	1,279	33,097	836	1,307	33,569
58	1,279	34,847	885	1,376	35,338
59	1,279	36,617	936	1,446	37,126
60	1,279	38,405	990	1,516	38,931
61	1,279	40,210	1,049	1,587	40,748
62	1,279	42,027	1,113	1,659	42,573
63	1,279	43,852	1,182	1,730	44,400
64	1,279	45,678	1,257	1,802	46,223
65	1,279	47,502	1,335	1,873	48,041
66	1,279	49,319	1,411	1,945	49,852
67	1,279	51,131	1,488	2,015	51,659
68	1,279	52,937	1,562	2,086	53,462
69	1,279	54,740	1,637	2,157	55,260

<u>Age</u>	<u>Premium</u>	<u>Post- Premium Cash Value</u>	<u>Cost of Current Insurance Protection</u>	<u>Interest Earned</u>	<u>Closing Cash Value</u>
70	1,279	56,539	1,717	2,227	57,049
71	1,279	58,327	1,804	2,297	58,820
72	1,279	60,098	1,901	2,366	60,563
73	1,279	61,841	2,009	2,433	62,266
74	1,279	63,545	2,121	2,499	63,923
75	1,279	65,201	2,234	2,563	65,531
76	1,279	66,810	2,341	2,626	67,094
77	1,279	68,373	2,439	2,686	68,620
78	1,279	69,898	2,526	2,745	70,118
79	1,279	71,397	2,604	2,804	71,596
80	1,279	72,875	2,681	2,861	73,055
81	1,279	74,334	2,759	2,918	74,494
82	1,279	75,772	2,841	2,974	75,905
83	1,279	77,184	2,926	3,029	77,286
84	1,279	78,565	3,006	3,082	78,641
85	1,279	79,920	3,071	3,135	79,984
86	1,279	81,262	3,112	3,188	81,339
87	1,279	82,617	3,121	3,242	82,738
88	1,279	84,017	3,089	3,299	84,227
89	1,279	85,505	3,005	3,360	85,861
90	1,279	87,139	2,852	3,429	87,716
91	1,279	88,994	2,608	3,508	89,894
92	1,279	91,173	2,237	3,602	92,537
93	1,279	93,816	1,683	3,719	95,852
94	1,279	97,131	999	3,868	100,000

TABLE 2
SINGLE PREMIUM CASH VALUE CONTRACT

<u>Age</u>	<u>Premium</u>	<u>Post- Premium Cash Value</u>	<u>Cost of Current Insurance Protection</u>	<u>Interest Earned</u>	<u>Closing Cash Value</u>
35	25,188	25,188	158	1,004	26,034
36	0	26,034	166	1,038	26,906
37	0	26,906	175	1,073	27,804
38	0	27,804	186	1,108	28,726

<u>Age</u>	<u>Premium</u>	<u>Post- Premium Cash Value</u>	<u>Cost of Current Insurance Protection</u>	<u>Interest Earned</u>	<u>Closing Cash Value</u>
39	0	28,726	199	1,145	29,672
40	0	29,672	212	1,183	30,642
41	0	30,642	228	1,221	31,635
42	0	31,635	243	1,261	32,653
43	0	32,653	261	1,301	33,693
44	0	33,693	278	1,342	34,757
45	0	34,757	297	1,384	35,845
46	0	35,845	316	1,427	36,956
47	0	36,956	335	1,472	38,093
48	0	38,093	355	1,517	39,254
49	0	39,254	377	1,563	40,439
50	0	40,439	400	1,610	41,649
51	0	41,649	426	1,657	42,881
52	0	42,881	455	1,706	44,132
53	0	44,132	487	1,756	45,401
54	0	45,401	522	1,806	46,685
55	0	46,685	558	1,856	47,983
56	0	47,983	596	1,907	49,294
57	0	49,294	633	1,959	50,620
58	0	50,620	671	2,011	51,960
59	0	51,960	710	2,064	53,315
60	0	53,315	751	2,118	54,681
61	0	54,681	795	2,171	56,058
62	0	56,058	843	2,225	57,440
63	0	57,440	896	2,280	58,824
64	0	58,824	953	2,334	60,205
65	0	60,205	1,012	2,388	61,581
66	0	61,581	1,070	2,442	62,953
67	0	62,953	1,128	2,496	64,321
68	0	64,321	1,184	2,549	65,686
69	0	65,686	1,241	2,603	67,047
70	0	67,047	1,302	2,656	68,401
71	0	68,401	1,368	2,709	69,741
72	0	69,741	1,442	2,761	71,060
73	0	71,060	1,523	2,812	72,349
74	0	72,349	1,609	2,862	73,602
75	0	73,602	1,695	2,910	74,817
76	0	74,817	1,776	2,957	75,998
77	0	75,998	1,851	3,003	77,150

<u>Age</u>	<u>Premium</u>	<u>Post- Premium Cash Value</u>	<u>Cost of Current Insurance Protection</u>	<u>Interest Earned</u>	<u>Closing Cash Value</u>
78	0	77,150	1,917	3,048	78,281
79	0	78,281	1,978	3,092	79,395
80	0	79,395	2,037	3,135	80,493
81	0	80,493	2,097	3,178	81,575
82	0	81,575	2,160	3,220	82,634
83	0	82,634	2,227	3,261	83,668
84	0	83,668	2,291	3,301	84,678
85	0	84,678	2,344	3,340	85,675
86	0	85,675	2,379	3,379	86,675
87	0	86,675	2,393	3,419	87,701
88	0	87,701	2,377	3,461	88,785
89	0	88,785	2,325	3,505	89,965
90	0	89,965	2,225	3,554	91,294
91	0	91,294	2,063	3,610	92,841
92	0	92,841	1,814	3,677	94,704
93	0	94,704	1,441	3,759	97,022
94	0	97,022	881	3,859	100,000