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Policyholder Tax Compliance

Southeastern Actuaries
Conference

Date: June 21, 2012



Agenda

Some Basic Tax Laws/Regulations

- Life Insurance
- Fixed Annuities
- Variable Annuities
- Viatical Contracts

Tax and Risk Management

What's New in Tax

Some Basic Tax Laws and Regulations

Life Insurance – IRC 7702

- **Insurance contracts:**
 - Involve an insurance risk;
 - Involve both risk shifting and risk distribution; and,
 - Constitute insurance in the commonly accepted sense

- **7702 defines ‘life insurance contract’**
 - Cash Value Accumulation Test
 - Guideline Premium
 - Guideline Single Premium
 - Guideline Level Premium
 - Cash Value Corridor

7702 and the SNFL

The interaction of the section 7702's CVAT(Cash Value Accumulation Test) and State Non Forfeiture Laws (SNFL) create a dual limitation on traditional life insurance contracts.

- CVAT limiting the maximum permissible cash value i.e. create a ceiling**
- SNFL requiring a minimum cash surrender value i.e. create a floor**

Hence a policy design must keep its cash surrender value (CSV) in between the ceiling and floor created by CVAT and SNFL.

Life Insurance – IRC 7702A – Modified Endowment Contracts

- **7702A defines Modified Endowment Contract (MEC)**
 - Meets 7702 Requirements but fails 7-pay test
 - MECs and Non-MECs qualify for tax deferred treatment of policy gains and tax-free receipt of death benefits
 - Additional Benefits Afforded to Non-MECs
 - When would you ever want a MEC?

COLI and BOLI

- **Initial Corporate Owned Life Insurance plan**
- **COLI Best Practices Act - 2006**

Qualified Plan Requirements

[Minimum Participation Requirements](#)

[Operate in Accordance with Plan Minimum Vesting Requirements](#)

[Minimum Distribution Requirements](#)

[Consent for Distribution Requirement](#)

[Joint and Survivor Annuity Requirements](#)

[Direct Rollover Requirements](#)

[Assignment or Alienation Prohibition](#)

[Nondiscrimination Requirements](#)

[Coverage Requirements](#)

[401\(a\)\(26\) Participation Requirement](#)

[Funding Requirements](#)

[Exclusive Benefit Requirement](#)

[Reporting and Disclosure](#)

What about Variable contracts?

Diversification Status under IRC Section 817(h)

Regulations provides that the investments of a segregated asset account will be considered adequately diversified if:

- No more than 55 percent of the value of the total assets of the account is represented by any one investment
- No more than 70 percent of the value of the total assets of the account is represented by any two investments
- No more than 80 percent of the value of the total assets of the account is represented by any three investments
- No more than 90 percent of the value of the total assets of the account is represented by any four investments.

Viaticals

A viatical settlement involves the sale of your life insurance policy once you have become chronically or terminally ill

Definition of terminal is expressed in years and varies from state to state and is typically two to four years – matters in determining taxation

Life expectancy beyond ‘terminal’ definition – partial taxation

Taxation of Policy Proceeds

- **Taxation of Internal Build up of Policy Values**
 - Life Insurance, non-MECs vs MECs
 - Deferred Annuities
- **1099**

Tax and Risk Management

Tax impacts several areas across the insurance business:

- Policyowner processing
 - Premium collection
 - Disbursements
 - Advice to policyowners
- Product design
- Corporate planning/analysis

It is critical that those persons who are communicating with individual policyholders know that tax impacts to the policyholders may exist and communicate appropriately. It is also critical that product designs and supporting systems consider the tax impacts as well.

The impact of penalties to the insurance company for disqualification of policies can be significant and may be applied on a per individual policy basis.

What's New in Tax

Definition of Insurance in the News

TAM 201149021: P&C application

IRS ruled that an insurance contract that insures against a decline in market value of assets leased to third parties is not an insurance contract for federal income tax purposes.

“Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk.”

In the news: BOLI

PLR 201152014 a partnership of banks formed to pool and manage the banks' BOLI contracts and, in the process, exchange some or all of them for new contracts. The contracts would be transferred to a limited liability company (LLC).

Benefits for Banks:

they would receive death benefits when paid under the Policies in proportion to their interests in the LLC

more effective, centralized way to manage Policies

Appropriately negotiate the terms of new Policies (i.e., via exchange) or renegotiate the terms of existing BOLI holdings

Favorable Tax Advantage- taxed as partnership vs. investment company

In the News: Qualified Longevity Annuity Contracts

Supporting Retirement for American Families (CEA) – longevity annuities’ value excluded in determining MDA

“an annuity contract (that is not a variable contract under section 817, equity-indexed contract, or similar contract) that is purchased from an insurance company for an employee.”

QLAC may also be purchased in an IRA, subject to rules

Thank you

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