PLR 200906001— A CONSERVATIVE TAXPAYER OR A VERY SUBTLE MESSAGE FROM THE IRS?

By Joseph F. McKeever, III and Daniela Stoia

Life insurance companies seek private letter rulings from the Internal Revenue Service (the "Service") for various reasons. For example, they may seek private letter rulings where the law is unclear[1] or they may seek to extend the application of the law beyond established authorities by obtaining a private letter ruling that "pushes the envelope."[2] Alternatively, insurers may seek a private letter ruling to level the playing field, *i.e.*, eliminate an advantage competitors may have gained by taking a questionable position. But, in contrast, it is unusual for insurers to seek a private letter ruling sanctioning a practice that seemingly is more conservative than both industry practice and the requirements of the Code. This, however, is what appears to have happened in PLR 200906001,[3] released on Feb. 6, 2009.

PLR 200906001 (the "PLR") addresses the "reasonable mortality charges" requirement of section 7702(c)(3)(B)(i). The PLR holds that life insurance contracts will not fail to satisfy the requirements of section 7702 or the 7-pay test of section 7702A(b) solely because a declaration of a discount to the current cost of insurance charges ("COIs" or "mortality charges") or the crediting of a discount to the current COIs pursuant to the terms of a "Wellness Rider" is not treated as an "adjustment event" under section 7702(f)(7)(A) or a "material change" under section 7702A(c)(3), provided that the mortality charges used in the initial section 7702 and 7702A calculations reflect the anticipated, but nonguaranteed, mortality discount provided under the Wellness Rider. As discussed below, the law seems quite clear that such reductions need not be reflected in the initial calculations under these Code sections, nor do they give rise to an adjustment or a material change. As a result, this PLR has left the authors, and others, wondering whether there is more to the PLR than meets the eye. Before speculating on what the PLR means, however, some more background on the PLR is in order.

THE WELLNESS RIDER

The PLR addresses a Wellness Rider that an affiliated group of life insurance companies proposed to offer on a prospective basis with newly issued life insurance contracts. The contracts would be offered under both the "cash value accumulation test"[4] and the "guideline premium test."[5] The companies did not propose to make the Wellness Rider available on their existing life insurance contracts. As a result, it is likely that the life insurance contracts to be issued with the Wellness Rider would be subject to the 2001 Commissioners' Standard Ordinary mortality tables ("2001 CSO" or "2001 CSO tables").

The Wellness Rider provides, in relevant part, a discount on the current COI charges (the "COI Discount") for individuals who periodically satisfy certain wellness qualification criteria (the "Wellness Rewards Benefit"). Specifically, in order to be eligible for the COI Discount under the Wellness Rewards Benefit, insureds must 1) complete a routine physical examination by a licensed physician, and 2) maintain a weight within a range established when the contract is issued as part of the initial underwriting process (the "Wellness Qualification Criteria"). If an insured satisfies the Wellness Qualification Criteria, then the contract covering the insured is allowed to participate in any COI Discount declared under the Wellness Rewards Benefit for the next two contract years.

It is quite clear from the facts described in the PLR that the COI Discount would not be guaranteed and that the mortality guarantees in the contracts issued with the Wellness Rider would not change by virtue of an insured satisfying the Wellness Qualification Criteria. In this regard, the PLR states that the companies expected the COI Discount to be declared annually, but that whether the COI Discount in fact would be provided was not guaranteed. Rather, the COI Discount would be set at the discretion of the companies, depending upon, for example, their future expectations of mortality and persistency for the cohort of insureds that satisfied and were expected to continue to satisfy the Wellness Qualification Criteria. If declared, the COI Discount would be applied to reduce the current mortality charges otherwise declared under the life insurance contracts issued with the Wellness Rider. However, even if a COI Discount was declared by the companies for a particular year, the discount (similar to the current mortality charges imposed under the contracts issued with the Wellness Rider) would not be guaranteed. In fact, the companies reserved the right to increase, reduce, or

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discontinue the COI Discount provided under the Wellness Rewards Benefit at *any* time.

For purposes of calculating the "guideline single premium"[6] (the "GSP"), the "guideline level premium"[7] (the "GLP"), the "net single premium"[8] (the "NSP"), and the "7-pay premiums,"[9] the companies proposed to reduce the COI charges otherwise taken into account under Notice 2006-95[10] by the amount of the anticipated COI Discount (*i.e.*, the amount by which the anticipated current mortality charges exceed the anticipated discounted mortality charges for the pool of contracts expected to qualify for the Wellness Rewards Benefit based on the companies' actuarial best estimates at contract issuance (the "Reduction Methodology")). Finally, the companies proposed not to treat the declaration of a discount to the current COIs or the crediting of a discount to the current COIs pursuant to the terms of the Wellness Rider as an adjustment event under section 7702(f)(7)(A) or a material change under section 7702A(c)(3).[11]

THE SERVICE'S ANALYSIS

The Reasonable Mortality Charge Rule

In calculating the NSP, GSP, GLP and 7-pay premiums, life insurers must follow the reasonable mortality charge rule of section 7702(c)(3)(B)(i). Thus, those calculations must reflect "reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued."[12]

In addition, the Service has issued interim safe harbor guidance regarding the reasonable mortality charge rule, most recently in Notice 2006-95. In relevant part, Notice 2006-95 provides that a mortality charge will satisfy the requirements of section 7702(c)(3)(B)(i) if 1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO tables; 2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and 3) either (a) the contract is issued after Dec. 31, 2008, or (b) the contract is issued before Jan. 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued (the "2001 CSO Safe Harbor").[13] For the reasons noted above, the 2001 CSO Safe Harbor likely applies to the contracts to be issued with the Wellness Rider.

After reviewing the reasonable mortality charge rule and the safe harbors set forth in Notice 2006-95, the Service stated that the companies requesting the PLR could use 100 percent of the mortality charges specified in the applicable CSO mortality tables (*e.g.*, 100 percent of 2001 CSO) in their section 7702 and 7702A computations for contracts issued with the Wellness Rider, without taking into account the COI Discounts provided under the Wellness Rider. This statement is consistent with the 2001 CSO Safe Harbor and is not surprising because both the availability and the amount of the COI Discount under the Wellness Rider would be wholly within the companies' discretion and would not be guaranteed or specified in the contracts with which the Wellness Rider would be issued. Thus, absent a mortality charge guarantee less than 2001 CSO,[14] the companies would be free to reflect in their initial section 7702 and 7702A calculations mortality charges that do not exceed 100 percent of the applicable mortality charges set forth in the 2001 CSO tables.

Nevertheless, according to the facts of the PLR, the companies proposed to reflect in their initial section 7702 and 7702A calculations mortality charges determined by reducing 100 percent of the mortality charges specified in the applicable CSO mortality tables (*i.e.*, the mortality charges in fact guaranteed under the contracts to be issued with the Wellness Rider) by the amount of anticipated COI Discounts. The Service observed that the guaranteed rates would not exceed 100 percent of the applicable CSO table charges and then stated that the companies' reflection of the reduced mortality charges complied with "the reasonable mortality charge requirement of § 7702(c)(3)(B)(i), as implemented by Notice 2006-95 and Notice 88-128."

Adjustments and Material Changes

Section 7702(f)(7)(A) requires "proper adjustments in future determinations" made under section 7702 if "there is a change in the benefits under (or in other terms of) the

contract which was not reflected in any previous determination or adjustment made under [section 7702].” Similarly, section 7702A(c)(3)(A) provides that “[i]f there is a material change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination under [section 7702A],” the contract must be treated as a newly issued contract as of the date of the change and appropriate adjustments must be made in determining whether the contract meets the 7-pay test to take into account the cash surrender value under the contract.

In the PLR, the Service further elaborated on the adjustment and material change rules by stating that *any* change in a mortality guarantee would be a change in the terms of a life insurance contract that gives rise to an adjustment event under section 7702(f)(7)(A) and a material change under section 7702A(c)(3)(A).[15] However, the PLR then observes, as discussed above, that the declaration of a COI Discount pursuant to the Wellness Rider would not change the mortality guarantees under a contract. Thus, the Service stated, a periodic declaration by the companies over the life of a contract that results in the discounting of current mortality charges would not result in either an adjustment event under section 7702(f)(7)(A) or a material change under section 7702A(c)(3)(A).

Rulings

Based on the foregoing, the Service ruled as follows:

1) A contract designed to satisfy the cash value accumulation test, which is issued with the Wellness Rider, “will not fail to satisfy [that] test solely because” the companies do not perform an adjustment under section 7702(f)(7)(A) or treat the contract as a newly issued contract each time the companies declare or credit a COI Discount due to the contract holder’s satisfaction of the Wellness Qualification Criteria, provided that the companies use the Reduction Methodology upon contract issuance in calculating the NSP.

2) A contract designed to satisfy the guideline premium test, which is issued with the Wellness Rider, “will not fail to satisfy the guideline premium limitation solely because” the companies do not perform an adjustment under section 7702(f)(7)(A) or treat the contract as a newly issued contract each time the companies declare or credit a COI Discount due to the contract holder’s satisfaction of the Wellness Qualification Criteria, provided that the companies use the Reduction Methodology upon contract issuance in calculating the GSP and GLP.

3) A contract issued with the Wellness Rider “will not fail to satisfy the 7-pay test set forth in § 7702A(b) solely because” the companies do not treat the contract as having undergone a material change within the meaning of section 7702A(c)(3) or otherwise as a newly issued or entered into contract each time the companies declare or credit a COI Discount due to the contract holder’s satisfaction of the Wellness Qualification Criteria, provided that the companies use the Reduction Methodology upon contract issuance in calculating the 7-pay premiums.

SO WHAT IS GOING ON HERE?

Perhaps what is most intriguing about this PLR is why the companies requested it in the first instance. Based on the facts as set forth in the PLR, there do not appear to have been any issues relating to whether the declaration of the COI Discounts could be characterized as giving rise to guarantees that reduced the otherwise applicable mortality guarantees under the contracts issued with the Wellness Rider. As a result, it is unclear why the companies proposed to adopt the Reduction Methodology in their calculations of the NSP, GSP, GLP, and 7-pay premiums. It is equally unclear why the companies were concerned that the declaration of the COI Discounts could give rise to adjustment events under section 7702(f)(7)(A) and material changes under section 7702A(c)(3)(A).

In considering the reasons the companies may have had for seeking the PLR, two possibilities come to mind. First, the Wellness Rider is somewhat novel and the companies may have wanted comfort from the Service that this novel benefit did not present any section 7702 or 7702A compliance issues. Even though the companies apparently requested rulings only on the issues discussed above, insurers sometimes use the ruling process as a means of identifying other issues that the Service may believe exist. Second, because similar benefits seem to be gaining in popularity in the industry, the companies may have concluded that having a PLR on the treatment of the benefit under sections 7702 and 7702A would provide a marketing advantage vis à vis their competitors. Neither of these two possibilities explain, however, why the companies would adopt such a conservative position.

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This leads one to wonder whether the companies did not originally propose to perform their calculations in the manner

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described in the PLR. Perhaps the companies requested rulings that 1) they did not need to take the anticipated mortality discount into account at issue, and 2) they did not need to treat the granting of the discount as an adjustment event or material change, but decided to change their proposal based on discussions with the Service. This is mere speculation on the authors' part, but it is not unusual for insurers to modify PLR requests based on Service feedback.

In this regard, while the rulings in the PLR seem more conservative than necessary under the 2001 CSO Safe Harbor, they do appear to reflect the philosophy embodied in the interim rule for reasonable mortality charges that accompanied the enactment of the reasonable mortality charge rule in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA").[16] The interim rule applies prior to the issuance of final regulations and states that section 7702(c)(3)(B)(i) will be deemed to be satisfied by "mortality charges which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware)."[17] What is puzzling is what applicability the TAMRA interim rule would have in light of the existence of the safe harbors set forth in Notice 2006-95.

CONCLUSION

It will be interesting to see what further statements, if any, the Service makes on the issues involved in the PLR. Pending additional guidance, however, it would seem that other insurers offering such non-guaranteed mortality charge discounts should not be constrained by the practices reflected in the PLR. Specifically, absent a mortality charge guarantee less than 2001 CSO, insurers should be free to reflect in their initial section 7702 and 7702A calculations mortality charges that do not exceed 100 percent of the applicable mortality charges set forth in the 2001 CSO tables. Likewise, again assuming that any wellness type discount provided to a policyholder is not guaranteed, insurers should not need to treat the temporary provision of such a benefit, *e.g.*, for one year, as an adjustment event or a material change. ◀

END NOTES

1. *See, e.g.*, PLR 9519023 (Feb. 8, 1995); PLR 9513015 (Dec. 30, 1994). In both of these private letter rulings the Service concluded that term rider coverage on the insured generally should be viewed as a qualified additional benefit (or "QAB") under section 7702, but as a death benefit and not a QAB under section 7702A(b). Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
2. *See, e.g.*, PLR 9741046 (July 16, 1997) (concluding that if a term rider on the primary insured continues until age 95 or later, then it is treated as a death benefit under both sections 7702 and 7702A).
3. Oct. 17, 2008. A private letter ruling is issued to a particular taxpayer and can be relied upon only by that taxpayer. *See* section 6110(k)(3). However, given the paucity of published guidance under sections 7702 and 7702A, insurers and their advisors tend to study private letter rulings issued under these sections in the same manner CIA analysts used to study photographs of the way the Kremlin leadership arranged itself on the May Day parade reviewing stand in the 1950s.
4. *See* section 7702(a)(1) and (b) (setting forth the requirements of the "cash value accumulation test").
5. In order for a life insurance contract that is treated as such under state law to satisfy the "guideline premium test" it must both meet the "guideline premium requirements" set forth in section 7702(a)(2)(A) and (c) and fall within the "cash value corridor" of section 7702(a)(2)(B) and (d).
6. *See* section 7702(c)(3) (defining the "guideline single premium").
7. *See* section 7702(c)(4) (defining the "guideline level premium").
8. *See* section 7702(b)(1) and (2) (describing the "net single premium").
9. *See* section 7702A(b) and (c) (describing the "7-pay test" and the "7 level annual premiums," referred to herein as "7-pay premiums").
10. 2006-2 C.B. 848, *supplementing* Notice 88-128, 1988-2 C.B. 540, and *modifying and superseding* Notice 2004-61, 2004-2 C.B. 596.
11. The companies also proposed to treat the Wellness Rider under section 7702(f)(5)(C) as an "additional benefit which is not a qualified additional benefit." Thus, the companies proposed not to reflect the charges imposed for the Wellness Rider in calculating the GSP, GLP, NSP, and 7-pay premiums.
12. In 1991, the Service issued proposed regulations regarding the reasonable mortality charge rule, although such regulations have not been finalized and thus are not effective. *See* Prop. Treas. Reg. § 1.7702-1(a)-(c).
13. *See* Notice 2006-95 section 4.03.
14. The PLR states "[t]he current mortality charges against which the COI discount will be applied will also not be guaranteed or specified in such contracts."
15. *Cf.* PLR 199929028 (Apr. 27, 1999) (holding that temporary guarantees for up to one year are properly treated as dividends rather than as changes in the benefits under (or in other terms of) a contract that should be treated as adjustment events under section 7702(f)(7)(A); Christian J. DesRochers, John T. Adney, Douglas N. Hertz & Brian G. King, Life Insurance & Modified Endowments: Under Internal Revenue Code Sections 7702 and 7702A, 94 (1st ed. 2004) (stating that "[t]emporary guarantees for up to one year are properly treated as dividends; longer guarantees may be dividends, but at some unspecified point the character of a temporary guarantee would change and an adjustment event or deemed exchange would occur").
16. Pub. L. No. 100-647.
17. TAMRA section 5011(c)(2).