Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

A revenue ruling describes the tax treatment of a cash distribution made in connection with a reduction in the benefits of a life insurance contract. See Rev. Rul. 2003-95, page 358.

Section 7702.—Life Insurance Contract Defined

(Also Section 72.)

Life insurance contracts; distributions made in connection with a change in benefits. This ruling describes the rules of section 7702(f)(7) of the Code regarding the tax treatment of a cash distribution made in connection with a reduction in the benefits of a life insurance contract.

Rev. Rul. 2003–95

ISSUE

How is a cash distribution upon a change in the benefits of a life insurance contract taxed under § 7702(f)(7) of the Internal Revenue Code?

FACTS

Situation 1. In Year 1, *A* purchased a life insurance contract with a $350,000 death benefit. The contract is a life insurance contract under applicable state law and meets the cash value accumulation test prescribed in § 7702(a)(1) and § 7702(b). The contract is not a "modified endowment contract" as defined in § 7702A.

Through the end of Year 4, *A* paid total premiums of $45,000 with regard to the contract. At the end of the Year 4, when the cash surrender value of the contract was $60,000, *A* surrendered 60% of the contract and received a cash distribution of $36,000. The death benefit under the contract decreased to $140,000 as a result of the partial surrender. Based on *A*'s age at the time of the partial surrender, the net single premium (determined under § 7702(b)) was $355 per $1000 of insurance coverage.

Situation 2. Same facts as Situation 1, except that the contract qualifies as a life insurance contract using the guideline premium/cash value corridor test of §§ 7702(a)(2), 7702(c), and 7702(d) rather than the cash value accumulation test. When the contract was issued, the guideline premium limitation was $80,500. Immediately after the partial surrender, the guideline premium limitation (determined under § 7702(c)(3)) was $265 per $1000 of insurance coverage and the cash value corridor percentage (determined under § 7702(d)) was 185.

Situation 3. Same facts as Situation 2, except that the partial surrender occurred 6 years after the issuance of the contract.

LAW AND ANALYSIS

Section 7702(f)(7)(B) provides that if the benefits under a life insurance contract are reduced during the 15-year period beginning on the issue date of the contract and a cash distribution is made to the policyholder as a result of the reduction in benefits, then § 72(e) (other than subsection (e)(5) thereof) applies to the portion of the cash distribution that does not exceed the applicable recapture ceiling. Under § 72(e)(2)(B), a distribution is included in gross income to the extent of the income on the contract. Income on the contract is the amount by which the contract's cash value (determined without regard to any surrender charge) immediately before the distribution exceeds the policyholder's investment in the contract (determined under § 72(e)(6)) at such time. *See* § 72(e)(3)(A). Accordingly, under § 7702(f)(7)(B), the gross income of a policyholder receiving a cash distribution upon a reduction in the benefits during the 15 year period following the issue date of the contract includes an amount equal to the lesser of— (i) the applicable recapture ceiling, (ii) the income on the contract, or (iii) the amount of the distribution. To the extent the distribution exceeds the amount included in gross income, the excess is treated as a tax-free recovery of investment in the contract. *See* § 72(e)(2)(B).

The applicable recapture ceiling under § 7702(f)(7) varies depending on when the reduction in benefits occurs and on which of the § 7702 tests is used to qualify the contract as a life insurance contract for federal tax purposes.

If the reduction in benefits occurs during the 5-year period beginning on the issue date of the contract and the contract qualifies as a life insurance contract by satisfying the cash value accumulation test, then § 7702(f)(7)(C)(i) provides that the applicable recapture ceiling equals the excess of— (1) the cash surrender value of the contract immediately before the reduction in benefits, over (2) the net single premium (determined under § 7702(b)) for the contract immediately after the reduction in benefits. If the contract qualifies as a life insurance contract under the guideline premium/cash value corridor test, then § 7702(f)(7)(C)(ii) provides that the applicable recapture ceiling is the greater of—

(1) the excess of— (A) the aggregate premiums paid under the contract immediately before the reduction in the contract's benefits, over (B) the adjusted guideline premium limitation for the contract; or

(2) the excess of— (A) the cash surrender value of the contract immediately before the reduction in the contract's benefits, over (B) the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits.

The first and third of the four amounts required for this calculation, the aggregate premiums paid under the contract immediately before the reduction in the contract's benefits and the cash surrender value, are known facts. The second amount, the adjusted guideline premium limitation for the contract, is calculated by subtracting from the original guideline premium limitation a guideline premium limitation (determined under § 7702(c)(2)) for the decrease in the contract's benefits. The guideline premium limitation is determined as of the date of the reduction in benefits using the attained age of the insured on that date. S. Rep. No. 313, 99$^{\text{th}}$ Cong. 2d Sess. 989 (1986); 1986–3 (Vol. 3) C.B. 989. The fourth amount, the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits, is calculated by dividing the death benefit of the contract immediately after the reduction by the applicable percentage set forth in § 7702(d).

If the reduction in benefits occurs more than 5 years but less than 16 years after the contract's issue date, a single recapture ceiling applies to all contracts. The recapture ceiling equals the excess of— (1) the cash surrender value of the contract immediately before the reduction, over (2) the maximum cash value that would be permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits. *See* § 7702(f)(7)(D).

In *Situation 1*, *A* received a $36,000 cash distribution upon the surrender of 60% of the benefits under the life insurance contract. Immediately before the surrender, the income on the contract was $15,000 [$60,000 − $45,000 = $15,000].

The partial surrender reduced the death benefit under *A*'s contract from $350,000 to $140,000. As the reduction in the benefits occurred within the 5-year period beginning on the issue date of the contract and the contract qualifies as a life insurance contract under the cash value accumulation test, the applicable recapture ceiling is determined under § 7702(f)(7)(C)(i). The recapture ceiling is the excess of the contract's $60,000 cash surrender value immediately before the reduction in benefits over the net single premium for the contract immediately after the reduction in benefits. On the date of the reduction in benefits, the net single premium was $355 per $1000 of insurance coverage. The net single premium for the contract's reduced death benefit was $49,700 [$140,000 × $355 ÷ $1,000 = $49,700]. The recapture ceiling, therefore, was $10,300 [$60,000 − $49,700 = $10,300].

Pursuant to § 7702(f)(7)(B), *A*'s gross income includes the portion of the distribution equal to the lesser of— (i) the applicable recapture ceiling ($10,300), (ii) the income on the contract ($15,000), or (iii) the amount of the distribution ($36,000). Accordingly, $10,300 is included in *A*'s gross income. The remaining $25,700 of the distribution is treated, under § 72(e)(5), as a return of a portion of the *A*'s $45,000 investment in the contract. *A*'s investment in the contract immediately after the partial surrender is $19,300 [$45,000 − $25,700 = $19,300]. *See* § 72(e)(6).

In *Situation 2*, the reduction in the benefits under *A*'s life insurance contract also occurred within the 5-year period beginning on the issue date of the contract. However, because the contract qualifies as a life insurance contract using the guideline premium/cash value corridor test, the applicable recapture ceiling under § 7702(f)(7)(C)(ii) is the greater of—

(1) the excess of— (A) the aggregate premiums paid under the contract immediately before the reduction in the contract's benefits, over (B) the adjusted guideline premium limitation for the contract; or

(2) the excess of— (A) the cash surrender value of the contract immediately before the reduction in the contract's benefits, over (B) the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits.

A paid aggregate premiums of $45,000 under the contract prior to the reduction of the contract's benefits. The adjusted guideline premium limitation for the contract immediately after the reduction of benefits is calculated by subtracting from the $80,500 original guideline premium limitation a guideline premium limitation for the amount of the decrease in the contract's death benefit. The partial surrender resulted in a $210,000 decrease in the death benefit under *A*'s contract. Immediately after the reduction in benefits, the guideline premium limitation was $265 per $1000 of insurance coverage. The guideline premium for the decrease in death benefits was $55,650 [$210,000 × $265 ÷ $1,000 = $55,650]. The adjusted guideline premium limitation for the contract immediately after the reduction in benefits, therefore, was $24,850 [$80,500 – $55,650 = $24,850]. The excess of the aggregate premiums paid under the contract over the adjusted guideline premium limitation was $20,150 [$45,000 – $24,850 = $20,150].

The cash surrender value of *A*'s contract immediately before the reduction in benefits was $60,000. Immediately after the reduction of benefits, the cash value corridor of § 7702(d) requires the contract's death benefit to be at least 185% of the contract's cash surrender value. The partial surrender reduced the contract's death benefit to $140,000. The maximum cash value permitted under the cash value corridor requirement, therefore, was $75,675 [$140,000 ÷ 1.85 = $75,675]. The cash surrender value of *A*'s contract immediately before the reduction in the contract's benefits was less than the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction in benefits.

As the $20,150 excess of the aggregate premiums paid under the contract over the adjusted guideline premium limitation was greater than the $0 excess of the cash surrender value of the contract immediately before the reduction in the contract's benefits over the maximum cash value permitted under the cash value corridor immediately after the reduction of the contracts benefits, the recapture ceiling was $20,150.

Pursuant to § 7702(f)(7)(B), *A*'s gross income includes the portion of the distribution equal to the lesser of— (i) the applicable recapture ceiling ($20,150), (ii) the income on the contract ($15,000), or (iii) the amount of the distribution ($36,000). Accordingly, $15,000 is included in *A*'s gross income. The remaining $21,000 of the distribution is treated, under § 72(e)(5), as a return of a portion of the *A*'s $45,000 investment in the contract. *A*'s investment in the contract immediately after the partial surrender is $24,000 [$45,000 – $21,000 = $24,000].

In *Situation 3*, the reduction in the benefits under *A*'s life insurance contract occurred more than 5 years but less than 16 years after the contract's issue date. Under § 7702(f)(7)(D), the recapture ceiling equals the excess of— (1) the cash surrender value of the contract immediately before the reduction, over (2) the maximum cash value that would be permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contracts benefits.

The cash surrender value of *A*'s contract immediately before the reduction in benefits was $60,000. The maximum permitted cash value under the cash value corridor requirement immediately after the reduction of benefits was $75,675 [$140,000 ÷ 1.85 = $75,675]. As the $60,000 cash surrender value of *A*'s contract immediately before the reduction in the contract's benefits was less than the $75,675 maximum cash value permitted under the cash value corridor requirement immediately after the reduction in benefits, the excess was $0. The applicable recapture ceiling, therefore, was $0.

Pursuant to section 7702(f)(7)(B), *A*'s gross income includes the portion of the distribution equal to the lesser of— (i) the applicable recapture ceiling ($0), (ii) the income on the contract ($15,000), or (iii) the amount of the distribution ($36,000). Accordingly, none of the $36,000 distribution is included in *A*'s gross income. The entire distribution is treated, under § 72(e)(5), as a return of a portion of the *A*'s $45,000 investment in the contract. *A*'s investment in the contract immediately after the partial surrender is $9,000 [$45,000 – $36,000 = $9,000].

HOLDING

In *Situation 1*, $10,300 of the cash distribution is included in *A*'s gross income. The remaining $25,700 of the distribution is treated as a return of a portion of the *A*'s $45,000 investment in the contract, which reduces *A*'s investment in the contract to $19,300.

In *Situation 2*, $15,000 of the cash distribution is included in *A*'s gross income. The remaining $21,000 of the distribution is treated as a return of a portion of the *A*'s $45,000 investment in the contract, which reduces *A*'s investment in the contract to $24,000.

In *Situation 3*, none of the cash distribution is included in *A*'s gross income. The entire $36,000 of the distribution is treated as a return of a portion of the *A*'s $45,000 investment in the contract, which reduces *A*'s investment in the contract to $9,000.

DRAFTING INFORMATION

The principal author of this revenue ruling is Stephen Hooe of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Kay Hossofsky at (202) 622–3970 (not a toll-free call).