UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re: Bk. No. 03-13597-JMD
Chapter 7

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Debtor

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Chapter 7 Trustee

MEMORANDUM OPINION

I. INTRODUCTION

On March 3, 2004, the Court held a hearing on the Chapter 7 Trustee's (the "Trustee") Objection to Debtor's Claim of Exemption (Doc. No. 11) (the "Objection") and the Debtor's Response (Doc. No. 14). The Debtor has claimed a variable appreciable life insurance policy (the "Policy") exempt under New Hampshire RSA 511:2(XIX) as a retirement plan. The Trustee has objected to the Debtor's claimed exemption, stating that the Policy is simply a life insurance policy which is not considered a retirement plan under the applicable state exemption statute.

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. FACTS

The Debtor seeks to exempt the Policy that provides a death benefit of $50,000 and has a variable cash value. The Debtor has claimed the Policy exempt under RSA 511:2(XIX) as a retirement plan. The Trustee has objected to the Debtor's characterization of the Policy as a retirement plan and insists that the Policy is an insurance policy, and, as such, fails to qualify under the New Hampshire retirement plan exemption. Accordingly, the Trustee requests turnover of the surrender value of the policy for the benefit of the Debtor's estate.[1]

III. VARIABLE APPRECIABLE LIFE INSURANCE

Before commencing any analysis of the legal effect of the provisions contained within the Policy, the Court was required to increase its vocabulary with numerous new words of art from the life insurance business. That effort was complicated by the fact that different insurance companies use different terms to describe identical features and sometimes use identical terms to describe different things.[2]

Basically, a variable life insurance policy[3] is a cash value form of life insurance. As in whole life insurance, the owner pays a premium that does not rise with advancing age or deteriorating health. Unlike a whole life policy, the owner of a variable life policy can choose the investment vehicle in which her premiums are invested and can switch among the available

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[1] As of November 25, 2003, the Policy had a surrender value of $7,279.30.

[2] The Court has been faced with a bewildering array of life insurance products including whole life insurance, universal life insurance, variable appreciable life insurance, variable whole life insurance, variable universal life insurance, variable annuity life insurance and modified endowment contracts.

[3] The terms "policy" and "contract" are used interchangeably by insurance companies.

options.[4] However, where a whole life policy offers a guaranteed rate of return on the policy's cash value, the variable life policy can earn substantially more, depending upon the actual performance over time of the investment vehicle chosen by the policy owner. The cash value can even grow to exceed the original face value and boost the death benefit of the policy. Of course the cash value may also decrease if the policy owner's selected investment vehicle loses value. The owner pays a fixed premium and is guaranteed a minimum death benefit.[5] When the owner dies, the beneficiary receives the face value of the policy plus any accumulated cash value. Before death the owner can borrow against the policy's cash value,[6] make withdrawals or surrender the policy for its cash value. Unlike more traditional forms of investment, such as mutual funds, the cash value builds up tax-free.

A. Death Benefit Options

There are two death benefit options that are generally available under variable life policies. One option, often referred to as the level death benefit option, makes the face amount both the

[4] In the instant case the policy is limited to fourteen options that are controlled by Prudential.

[5] Periodic payment of at least a specified minimum premium amount will prevent the policy from lapsing, even if cash value is sufficient for the deduction of charges, then there will be no lapse even if payments have been less than the "minimum." In effect, payments that aggregate to at least the minimum as of each measuring date keep the policy's death benefit guarantee in force. Reinstatement of a lapsed policy can occur if payment of certain fees, interest and/or underwriting is performed.

[6] The premiums invested, after sales commissions and expenses, plus earnings.

minimum[7] and the maximum[8] death benefit. The other option equates the death benefit to the face amount plus cash value.[9]

If the owner of the policy wants positive investment performance to be reflected in growth of cash value, then the level death benefit option is best. If on the other hand she wants positive investment performance to be reflected in a larger death benefit, the second option is best.

In either option, the death benefit is required to be at least some specified multiple of cash value in order for the policy to retain its status as a life insurance policy under the IRC. When the cash value grows beyond the permitted point, then the death benefit will increase so that adverse tax law consequences are avoided.

B. Cash Value Access

There are three basic ways for a policy owner to access the cash surrender value of the policy without dying. First, the policy may be surrendered. This is analogous to a total redemption by a mutual fund shareholder. The policy owner is paid cash value minus any deferred charges and expenses.

Second, the policy owner may make a partial withdrawal whereby only part of the cash surrender value is paid. A partial withdrawal will usually cause the policy's face amount to be reduced. Both a surrender and a partial withdrawal can have income tax consequences, but not tax penalties.

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[7] Absent any policy loans.

[8] Unless it violates certain provisions of the Internal Revenue Code (the "IRC"), 26 U.S.C. § 1 et seq.

[9] The Debtor chose this option when she purchased the Policy.

The third and final way is taking out a policy loan. The loan is not considered as taxable income, but as debt and accordingly, has no tax consequences or penalties that arise as a result of the loan. Neither the IRC nor any federal statute regulates when and how much may be withdrawn using any of the above methods.

C. Taxes

Death benefit proceeds are generally not taxable to anyone, so long as the policy qualifies as a life insurance policy under the IRC. See IRC § 7702. However, the tax treatment of other aspects of the policy will depend upon whether the policy meets the definition of life insurance under the IRC. If the policy qualifies as life insurance then the cash build up of earnings accumulates tax free, loans are considered debt and are not a taxable event and there are no tax penalties associated with withdrawals.

IRC § 7702 sets out two "tax tests": a cash value accumulation test;[10] and a guideline premium/cash value corridor test.[11] It is not sufficient to meet the test once; it must be met throughout the life of the policy.

Additionally, a certain class of life insurance policies are also considered Modified Endowment Contracts ("MEC"). An MEC is defined as any policy that qualifies as life insurance

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[10] In general the sum of the premiums paid cannot exceed the greater of (1) the single premium necessary to fund the contract at the time of the issuance of the policy; or (2) the sum of the level premiums necessary (based on specified assumptions) to fund future benefits under the contract. IRC § 7702(b)

[11] Under a cash value corridor requirement, at any given age the policy death benefit must exceed the policy cash value by a particular percentage. These percentages start at 250 for age 40 and reduce gradually until age 75. For ages 75 through 90, the percentage remains at 105, and at age 91 the percentage decreases 1 percent each year until 100 percent is reached at age 95. The cash value must not at any time exceed the net single premium necessary (based on specified assumptions) to fund future contract benefits. IRC § 7702(c)

under IRC § 7702 but fails to meet the "seven-pay test."[12] The seven-pay test is not met if the accumulated amount paid at any time during the first seven years is more than the total of the net level premiums that would normally have been paid on or before such time if the policy provided for paid up future benefits after payment of seven level annual premiums. IRC § 7702A(b). The intent of Congress in creating the seven-pay test is clear. If the policy provides an incentive for earnings comparable to other types of investments (i.e., mutual funds, IRA's), even though life insurance is present in substantial amounts, the policy owner will lose the tax benefits of his policy and instead be subject to the restrictions of an MEC.

If a policy becomes classified as an MEC then loans are treated as income and become a taxable event. There is also a ten percent tax penalty for any withdrawals that occur before the age of 59 ½.

IV. DISCUSSION

There is no question that the Policy at issue is a life insurance policy. Paragraph five of the Debtor's Response quotes from the prospectus that states, "We believe we have taken adequate steps to ensure that the contract qualifies as life insurance of tax purposes." See Doc. No. 14. In fact, the prospectus and the Policy itself make it clear that this a life insurance policy. Exhibit 1, p. 4 ("A variable appreciable life insurance policy is a flexible form of life insurance."); Exhibit 2, p. 2 ("This is a contract of life insurance.").

Even though it is labeled as a life insurance policy, the Debtor contends that the Policy is intended for retirement savings. Exhibit A to the Debtor's Response purports to be evidence that

[12] In order to curb the use of life insurance as a tax-sheltered investment, Congress enacted IRC § 7702A as part of the Technical and Miscellaneous Revenue Act of 1988.

the issuer of the Policy, Prudential Financial ("Prudential"), actively markets these types of policies as retirement savings vehicles. See Doc. No. 14. Unfortunately, a close reading of Prudential's "marketing" reveals just the opposite, "The primary purpose of life insurance is to provide for surviving family members." Doc. No. 14. The only mention of "retirement" in the marketing description states that, "You can withdraw or borrow funds against the policy to supplement retirement income." Id.

The Court notes that in 1999 Prudential paid a $20 million fine for violating federal securities laws and $1 billion in restitution was paid to policy holders who were misled in purchasing variable life insurance policies as investments or retirement plans. Amy Westfeldt, *NASD Regulation fines Prudential subsidiary $20 million*, Associated Press, July 8, 1999. In February 2004, securities regulators began an investigation into Northwestern Mutual Life Insurance Company's marketing of variable life insurance policies. Gene Myer, *Inquiry touches KC area agent: Insurance policies are under review*, Kansas City Star, February 21, 2004. Policyholders there sued claiming that they were misled into thinking that the variable life insurance policies they purchased were retirement plans rather than insurance. Id. It is clear to the Court that the sale of these incredibly complex insurance policies has resulted in the confusion of many policy owners. The Debtor may well have believed that she was purchasing a retirement vehicle, however, that does not change the Policy's treatment under the state exemption statute.

The state exemption statute, RSA 511:2 XIX, provides:

> Subject to the Uniform Fraudulent Transfer Act, RSA 545-A, any interest in a retirement plan or arrangement qualified for tax exemption purposes under present or future acts of Congress; provided, any transfer or rollover contribution between retirement plans shall not be deemed a transfer which is fraudulent as to a creditor under the Uniform Fraudulent Transfer Act. "Retirement plan or arrangement qualified for tax exemption purposes" shall include without limitation, trusts, custodial accounts, insurance, annuity contracts, and other properties and rights

> constituting a part thereof. By way of example and not by limitation, retirement plans or arrangements qualified for tax exemption purposes permitted under present acts of Congress include defined contributions plans and defined benefit plans as defined under the Internal Revenue Code (IRC), individual retirement accounts including Roth IRAs and education IRAs, individual retirement annuities, simplified employee pension plans, Keogh plans, IRC Section 403(a) annuity plans, IRC Section 403(b) annuities, and eligible state deferred compensation plans governed by IRC Section 457. This paragraph shall be in addition to and not a limitation of any other provision of New Hampshire law which grants an exemption from attachment or execution and every other species of forced sale for the payment of debts. This paragraph shall be effective for retirement plans and arrangements in existence on, or created after, January 1, 1999, but shall apply only to extensions of credit made, and debts arising, after January 1, 1999.

The Debtor contends that the Policy qualifies for the state exemption because the plain reading of the statute clearly states that an "arrangement qualified for tax exemption purposes under present or future acts of Congress," which may include "insurance," is exempt.

The Court disagrees. Such a broad reading of the statute would lead to results not intended by the New Hampshire legislature. For example, many people consider the equity in their home as a retirement fund. Virtually all sellers (except those at the highest end of the market) can keep any profits they make on the sale of a house tax free, making home ownership a potentially lucrative long-term savings vehicle. If an individual creates a trust, to hold title to his home, does that trust now become an exempt asset under this statute? According to the Debtor's reading of the statute the answer would be yes, because of the tax exempt/deferral treatment for gain on a personal residence and because the word "trust" is specifically mentioned in the statute. If the Debtor's reading of the statute is correct, would a trust holding tax exempt bonds qualify for an exemption as a retirement account?

The Court believes that the statute was written to express a legislative policy favoring exemption of retirement arrangements without narrowly defining which arrangements would qualify. Accordingly, the question of whether a particular arrangement qualifies for an exemption

should not depend solely on the literal language of the statute. An arrangement that qualifies must come within the legislative policy of the statute. In determining the legislative policy expressed in the statute, the Courts finds the stated examples particularly helpful.[13] All of the retirement vehicles listed in the statute contemplate long term investments with significant penalties for withdrawals or surrenders before the age of 59 ½.[14] The Policy in the instant case contains no such limitations. In fact, the Debtor may freely withdraw/loan the cash value without any tax penalty at any time.

All of the retirement vehicles listed involve a trade off. An individual can invest her money with certain advantageous tax benefits in the future, but must forfeit access to the money until retirement or face a severe tax penalty. And because the tax penalty makes the investment virtually untouchable by the owner, the legislature has decided, as a policy matter, to protect such investments from the claims of creditors. However, where the owner has unlimited access to his money without a tax penalty, such as with mutual funds, the legislature has made such investments available to satisfy the claims of creditors.

V. CONCLUSION

Accordingly, since the Debtor has full access to the cash value of the Policy without a penalty the variable appreciable life insurance policy in this case is not the type of plan or arrangement which the legislature intended to be protected by the exemption in RSA 511:2(XIX). The Trustee's Objection is sustained.

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[13] Even though variable life insurance policies have existed for years (e.g., the Policy in the instant case was issued in 1986), the exemption statute enacted in 1998, effective January 1, 1999, does not mention them by name.

[14] Subject to certain limited exceptions.

This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052. The Court will issue a separate order consistent with this opinion.

Dated: April 21, 2004

/s/ J. Michael Deasy
J. Michael Deasy
Bankruptcy Judge