

*The 2001 CSO  
Mortality Table –  
The Time is Now*

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*Overview*

- Federal Tax Issues
  - Section 807 Tax Reserves
  - Section 7702 Limitations
  - Section 7702A Limitation

## *Federal Income Tax Issues*

- Section 807 tax reserves.
  - Prevailing commissioners' standard table.
- Definition of life insurance.
  - “Reasonable mortality” under section 7702 and 7702A limitations.

## *Prevailing Commissioners' Standard Table*

- The Prevailing Commissioners' Standard Table:
  - The most recent commissioners' standard tables.
  - Prescribed by the NAIC.
  - Permitted to be used for valuing reserves for that contract.
  - Under the insurance laws of at least 26 states.
  - When the contract was issued.

## *Prevailing Commissioners' Standard Table*

- At least 26 state adoptions have occurred already.
- The 2001 CSO will be prevailing on 1/1/2005.

## *Prevailing Table Implementation*

- Transition to a new table has little precedent.
  - 1980 CSO was prevailing in 1983 when tax reserve rules adopted in 1984.
  - 1980 CSO was mandated on 1/1/89 when reasonable mortality rules were adopted.

## *Transition Rules under Section 807*

- Section 807(d)(5)(B).
  - Three year transition period.
    - Begins 1/1/2005.
    - Ends 1/1/2008.
  - Remember – 2001 CSO is required for all products beginning 1/1/2009.

## *Lowest Reserve Rule*

- Which 2001 CSO Table is the Prevailing Table?
  - There are choices.
    - Ultimate v. Select & Ultimate.
    - Smoker distinct or composite rates.

## *“Reasonable Mortality” Requirements*

- Section 7702 and 7702A limitations are based on “reasonable mortality charges.”
- Reasonable mortality applies to:
  - Guideline premiums
  - Net single premiums
  - 7-pay premiums

## *Issues Particular to the 2001 CSO*

- When is 2001 CSO mortality “reasonable”?
- Which 2001 CSO table(s) should be viewed as “reasonable”?
- How will 2001 CSO mortality work with section 7702/7702A computations?

## *When is the 2001 CSO “Reasonable”?*

- Section 7702 requires use of 2001 CSO mortality for a contract issued after it becomes “prevailing.”
  - Does section 807 three-year transitional period apply?
- IRS guidance is expected...not sure when?
  - In conformity with section 807?
  - As each state permits its use?
  - As provided for in the Model Regulation?
  - By a uniform date nationwide?
  - . . . .

## *Suggested Guidance for Transition*

- ACLI’s suggested guidance to Treasury/IRS:
  - Until 1/1/2009:
    - Use 1980 CSO except for contracts issued using 2001 CSO.
    - 2001 CSO is a safe harbor for 2001 CSO plans.
  - After 1/1/2009, only safe harbor is 2001 CSO.
  - Contracts undergoing material changes or adjustments.
    - Continue to use 1980 CSO mortality, other than when contracts are formally exchanged.

## *Which 2001 CSO Tables Are “Reasonable”?*

- Will insurers have flexibility in the choice of a table for a given contract/plan?
- IRS issued guidance regarding the 1980 CSO tables.
  - Notice 88-128.
  - Proposed regulations.
- Industry’s hope: use of flexibility in proposed regulations as the model for future guidance.

## *Potential Legislative Concerns*

- The 2001 CSO Tables end at age 121.
- How should the section 7702/7702A limits be calculated beyond age 100?
  - Might the cash value corridor be extended to 121?
  - Might the section 7702(e)(1)(B) maturity date be extended to age 121?

## *Change in Tax Limitations*

| <b>Ratio of 2001 CSO to 1980 CSO Values</b> |             |             |
|---|-------------|-------------|
| Test Premium                                | Male        | Female      |
| GSP   | 75 to 85%   | 75 to 90%   |
| GLP – Option 1                              | 75 to 85%   | 80 to 85%   |
| 7-Pay                                       | 80 to 85%   | 85 to 90%   |
| GLP - Option 2 E @95                        | 75 to 80%   | 70 to 75%   |
| GLP - Option 2 E @121                       | 150 to 160% | 155 to 170% |

## *Change in Tax Limitations: An Example*

| <b>2001 CSO ANB Ult.: Endowment Age 100 v. 121<br/>(Male 55 NS - Rate per 1,000)</b> |             |             |
|--|-------------|-------------|
| Test Premium   | Endow @ 100 | Endow @ 120 |
| GSP  | 271.60      | 270.86      |
| GLP – Option 1   | 25.64       | 25.52       |
| GLP - Option 2   | 53.74       | 107.38      |
| 7-Pay  | 65.39       | 65.21       |
| NSP  | 400.01      | 398.89      |

## *Interim Solutions*

- **Pending Guidance:**
  - Apply 2001 CSO for plans based on 2001 CSO.
    - Subject to consistency rules.
  - Early focus likely to be on DB products.
    - Stay within the 7702 rules.
      - Limit terminal age to 100.
      - Follow current practice for extended maturity.
  - Review system limitations for 2001 CSO.

## *The 2001 CSO Mortality Table – The Time is Now*

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## Revenue Ruling 2003-95

### Forceouts and the Recapture Ceiling

The purpose was to show the operation of 7702(f)(7)(B)-(E)

- Normally, distributions from non-MEC life contracts are taxed on a “FIFO” basis: tax applies only after all premium has been recovered. The other extreme is “LIFO,” in which taxable gain comes out first.
- This favorable rule has an exception created by the above referenced provisions

## The Rule

- If benefits are reduced during the first 15 contract years, and this results in a cash distribution to the policyholder –
- The LIFO rule will be applied to that part of the distribution that does not exceed the “Recapture Ceiling”
- A two year look-back applies

## The Recapture Ceiling

- In the first 5 contract years, the recapture ceiling depends on the 7702 test for the contract – it is the amount of “forced out cash” created by the reduction
- In years 6-15, only the premium test corridor is used, even for CVAT contracts, to measure the amount forced out

## Ceiling Continued

- In 6-15 the ceiling is the amount of cash the 7702(d) corridor would have forced out, due to the reduction, if it applied to the contract
- Roughly, hit the distribution in the first 5 years to the full extent of the sin (there was cash in the contract not allowed there after the reduction); in years 6-15, hit less.

## My Attitude Problem

- Aside from extreme situations the rules here don't seem to me to do much of anything.
- I tried to make the ruling situation more than a bunch of illustrative random numbers to see if I was wrong: i.e. create a "real" example fitting the rulings numbers to see how it would "really" work

## Situation

- A male age 47 buys a \$350,000 life contract and reduces it 4 years later (age 50) by \$210,000 to \$140,000, with \$36,000 cash taken out
- Premium paid was \$45,000; cash value before distribution was \$60,000; gain was \$15,000
- 7-pay premium for the issued contract would be \$18,760, so the contract could be a non-MEC: pay \$11,250 each year for 4 years, for example

## CVAT Contract: 4.5% 1980 CSO

- NSP at 50 is \$358.54 per \$1000, or \$50,195 for \$140,000
- Recapture ceiling:  $\$60,000 - \$50,195 = \$9,805$ . This amount is taxable, as gain is greater.
- $\$36,000 - \$9,805 = \$26,195$  reduces basis from \$45,000 to \$18,805
- Not a dramatic effect – not much forced out: only 27.2% of the distribution is taxed

## GPL/CVC Contract: 3% loading

- GSP at issue age 47 is \$245.52 per \$1000, or \$85,932 total for \$350,000
- GLP at issue is \$21.32 per \$1000, or \$7,462 total for \$350,000
- At time of reduction, the GSP is \$85,932 and sum of GLPs is \$29,848 (4 GLPs), so the GPL is \$85,932 before adjustment

## GPL/CVC Continued

- At age 50, GSP and GLP per \$1000 are \$278.47 and \$24.81 respectively. For the \$210,000 decrement this gives \$58,478 and \$5,210 respectively
- So, after reduction, we compute separately
$$\text{GSP} = \$85,932 - \$58,478 = \$27,454$$
$$\text{Sum GLP} = \$29,848 - \$5,210 = \$24,638$$
Future annual net GLP increments will be
$$\$7,462 - \$5,210 = \$2,252$$

## GPL/CVC Continued

- The new GPL is \$27,454, so  $\$45,000 - \$27,454 = \$17,546$  is forced out by GPL
- The 7702(d) corridor will allow  $\$140,000/1.85 = \$75,675$  cash value in the contract, and so would force \$0 out. The taxable part of the distribution is capped at \$17,546 (The greater of the two). So the taxable part is \$15,000, the total gain.

## GPL/CVC Continued

- $\$36,000 - \$15,000 = \$21,000$  reduces basis from \$45,000 to \$24,000
- 7702(f)(1)(A) says premiums paid is also reduced by the taxable amount, so this becomes  $\$24,000 - \$15,000 = \$9,000$
- Note that premiums paid and basis can be different

## Final Note – It's a MEC

- At reduction we must retest from issue using a 7-pay premium based on \$140,000. This gives us \$7,504. The contract became a MEC, and all \$15,000 of the distribution was taxable in both cases.
- The moral of the story is: it is hard to find a use for 7702(f)(7)(B) now that contracts subject to it are also subject to 7702A. Extreme reductions in years 8 – 15 can produce tax, but that's about it.

## What We Got

- We now have official guidance on how adjustment calculations are done
- The answer is attained age layering, or attained age increment/decrement
- If your company has been doing something else, it's time to rethink your position

## Family Term and Other QABs

Mortality or Other Charge?

### Background

- Family term coverage is a QAB under 7702 and 7702A
- Charges for QABs are treated as future benefits under 7702(f)(5)
- In 1988 the rule changed from mortality and other charges specified in the contract to reasonable mortality and reasonable charges other than mortality

## Background

- Other charges are “reasonable” if reasonably expected to be actually paid
- For mortality, Notice 88-128 allows 1980 CSO mortality as a safe harbor regardless of what is actually charged
- Actual charges for family term QABs are often substantially less than 1980 CSO costs

## Waivers

- Under 7702(f)(8) the IRS can waive contract failures caused by “reasonable error.” This is done by letter ruling.
- These rulings may not be used or cited as precedent (IRC 6110(k)(3)), but are often our only source for IRS positions under 7702

## The Problem

- Letters 200150014, 200150018, 20027036 and 200320020 address the question whether charges for family term and other QABs are to be treated as mortality charges or as other charges
- IRS concluded in each case the charges are other charges not subject to the safe harbor

## Theories

- Some have reasoned that charges for term riders are clearly mortality charges
- In 200150018, actuaries noted that QAB charges are treated as death benefits under 7702(f)(5) and hence mortality charge treatment is proper
- In 200320020, mortality charge treatment was given to waiver riders, possibly on the above theory

## IRS Position

- 7702(b)(2)(B) provides that the NSP for the CVAT is computed treating QAB charges as other reasonable charges
- In the absence of any other statutory guidance, IRS concludes other charge treatment applies to GPL/CVC also
- In all four cases IRS gave a reasonable error waiver under 7702(f)(8) to the issuing companies

## The Future

- Companies with this problem can seek a waiver (or closing agreement) or maintain their position – hardly an attractive choice to have to make
- John's firm has a group of companies addressing the resolution of this situation. They want a published ruling with effective date relief
- Status?

# **Federal Tax Developments: COLI Legislation, BOLI Audits, & Section 412(i) Guidance**

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## **COLI: Federal Tax & Related Developments**

- Tax legislation pending in Congress
  - Background
  - Details of proposal
- Compliance with current law
  - Issues raised in BOLI “IDRs”
  - Potential fallout of recent litigation
  - Tax shelter considerations

## **COLI in Congress: Background**

- Articles on COLI in *Wall Street Journal*, other media outlets
- Rep. Green's bill: notification
- Sen. Bingaman's proposal: denial of death benefit exclusion, with certain exceptions
- Senate Finance Committee actions & life insurance industry reactions in 2003

## **COLI: Details of Proposal**

- New section 101(j) of Internal Revenue Code approved by Senate Finance Committee on 2/2/04
- Replaces Bingaman proposal (more adverse to COLI) adopted 10/03
- Limits employees covered; requires consent, notice, & reporting
- Maintains date-of-enactment effective date

## **COLI: Details of Proposal (cont.)**

- Section 101(j)(1) general rule: death proceeds of COLI covering an employee – “employer-owned life insurance” – taxable to employer (in excess of premiums paid)
- Exceptions provided to general rule (*i.e.*, certain proceeds remain tax free)
- Significant “key employee” exception in definition of “employer-owned”

## **COLI: Details of Proposal (cont.)**

- Exception to general rule for employee death during employment or within 12 months of leaving employment
- More exceptions – proceeds payable to:
  - Employee’s family member or designated beneficiary (other than employer)
  - Trust for any of above
  - Purchase equity interest in employer

## **COLI: Details of Proposal (cont.)**

- Definition & key employee exception – section 101(j)(2)
- Contract owned by & directly or indirectly benefiting entity engaged in trade or business covering US citizen or resident employee (or employee of affiliate)
- “Employee” includes officer, director, & highly compensated employee

## **COLI: Details of Proposal (cont.)**

- Key employee exception – employer-owned life insurance does not include coverage of:
  - Highly compensated employee (HCE) as defined in section 414(q) (5% owner or earning \$90,000 or above)
  - Highly compensated individual as defined in section 105(h)(5), including highest paid 35%
  - Any director

## **COLI: Details of Proposal (cont.)**

- Under notice & consent requirements of section 101(j)(3), which must be met for *any* exception to apply, employee must:
  - be notified of employer's intent to secure & benefit from coverage in amount not exceeding amount stated in notice, and
  - have consented in writing to be insured & remain so after employment terminates

## **COLI: Details of Proposal (cont.)**

- Reporting requirement imposed on employers maintaining COLI on employees by new section 6039I
- Must report total # of employees, # insured, total COLI face amount, etc.
- Report must certify compliance with notice & consent requirements

## **COLI: Details of Proposal (cont.)**

- Effective date of section 101(j):
  - Contracts issued after date of enactment
  - Exception for section 1035 exchanges
  - Material death benefit increases or other material changes = new contracts
- Effective date of section 6039I: reporting to begin in 2004
- Prospects for enactment

## **Compliance with Current Law: Issues Raised in BOLI “IDRs”**

- Insurable interest and insured consent
- Transfer of risk and experience rating
- “Investor control”
- Business purpose
- Deductibility of interest, related expenses

## Recent Case Law: Potential Fallout

- *Mayo* case (a.k.a. *Wal-Mart*)
  - Wal-Mart established Georgia trust to hold COLI
  - Issues: insurable interest & choice of law
  - Decisions of District Court & Fifth Circuit
    - Texas law applied, Georgia law did NOT apply
    - Wal-Mart did not have insurable interest under Texas law
  - Result: Wal-Mart lost all tax & economic benefits of COLI program

## Recent Case Law: Potential Fallout (cont.)

- Leveraged COLI litigation
  - Insurable interest as section 7702 requirement
    - “Applicable law” requirement under section 7702
    - Generally means state law, which subsumes insurable interest & other requirements (*Dow Chemical*)
  - Focus on adequacy of risk shifting
    - “Mortality neutrality” in leveraged COLI cases
    - Positive treatment of experience rating in *Dow Chemical* case

## **Compliance with Current Law: Tax Shelter Considerations**

- IRS/Treasury campaign against tax shelters
- 2003 regulations
  - Tax return disclosure
  - Listed transaction
  - List maintenance
- Broad definition, specific triggers

## **Tax Shelter Considerations (cont.)**

- Triggers relevant to COLI/BOLI:
  - “Confidential transactions”
    - Confidentiality must relate to tax strategies
    - Minimum fee for advisor imposing the confidentiality requirement
  - Transactions with significant “book-tax difference”
    - Exceptions for life insurance proceeds & inside buildup (Rev. Proc. 2003-25)

## **Section 412(i) Guidance**

- Proposed regulations, revenue rulings & revenue procedure issued on 2/17/04
- Purpose: end tax abuse in “section 412(i) plans,” *i.e.*, tax-qualified plans based solely on life insurance and annuity contracts
- Guidance has broader ramifications

## **Section 412(i) Guidance, cont.**

- Proposed regulations:
  - Account for compensatory transfer of life insurance contract at “fair market value”
  - Probably cannot use “cash surrender value” to measure income from qualified plan, section 79 plan, or other transfer (section 83)
  - Fair market value not defined; ideas invited

## **Section 412(i) Guidance, cont.**

- Section 83 prop. regs. substitute “policy cash value,” as used in split dollar regs.
- Rev. Proc. 2004-16: pending final regs., may use a contract’s accumulation or account value as FMV
- Other rules issued are specific to section 412(i) plans

## **Section 412(i) Guidance, cont.**

- Section 412(i) plan rulings:
  - Cannot use contracts that fund for more than retirement plan benefits (Rev. Rul. 2004-20)
  - Employer cannot deduct excessive contributions – “listed transaction” (*id.*)
  - Plan cannot allow HCEs to purchase contracts pre-retirement on more favorable terms than non-HCEs (Rev. Rul. 2004-21)

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