
SOCIETY OF ACTUARIES

Article from:

# Product Development News

March 2005 – Issue 61

# Notice 2004-61:

## Guidance on Mortality under IRC Section 7702

by John T. Adney and Craig R. Springfield

Last fall, the Internal Revenue Service (IRS) released Notice 2004-61, 2004-41 I.R.B. 596 (October 12, 2004), interpreting the reasonable mortality charge requirement applicable to life insurance contracts under Section 7702 of the Internal Revenue Code. This notice supplements, and may modify in certain respects, guidance that the IRS provided in 1988 through Notice 88-128.

The subject of Notice 2004-61 is Section 7702(c)(3)(B)(i), which sets out the mortality charge assumption that is permitted to be used in determining net single premiums and guideline premiums, under Section 7702. In particular, this Code provision states that such determinations must be based on "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." This same mortality charge requirement applies for purposes of the 7-pay test under section 7702A, which defines a modified endowment contract for federal tax purposes. The impetus for the issuance of Notice 2004-61 was that the 2001 Commissioners' Standard Ordinary (CSO) mortality tables became the prevailing tables within the meaning of Section 807(d)(5) during 2004, and thus guidance on the transition from the previously applicable 1980 CSO tables to the new 2001 CSO tables was needed.

### Safe Harbors

Notice 2004-61 provides three safe harbors that will apply pending the publication of additional guidance. The first safe harbor provides that the interim rules described in Notice 88-128 remain in effect "except as otherwise modified by this notice." (Notice 88-128 included, for example, a safe harbor allowing use of mortality charges that do not exceed 100 percent of the applicable mortality charges set forth in the 1980 CSO tables.) The second safe harbor provides that, for a life insurance contract issued before January 1, 2009 in a state that permits or requires use of the 1980 CSO tables at the time the contract is issued, use of mortality charges in calculations under Section 7702 will satisfy the requirements of Section 7702(c)(3)(B)(i) if they do not exceed the lesser of (a) 100 percent of the charges set forth in the 1980 CSO tables and (b) the mortality charges specified in the contract at issuance. The third safe harbor provides that, for a life insurance contract issued after December 31, 2008, or on or before that date in a state that permits or requires use of the 2001 CSO tables at the time a contract is issued, use of mortality charges in calculations under Section 7702 will satisfy the requirements of Section 7702(c)(3)(B)(i) if they do not exceed the lesser of (a) 100 percent of the charges set forth in the 2001 CSO tables and (b) the mortality charges specified in the contract at issuance.

## Gender and Smoker Variations to CSO Tables

In addition to the above safe harbors, Notice 2004-61 provides guidance regarding gender and smoker-based variations of the 1980 CSO and 2001 CSO tables. In particular, if a state permits minimum nonforfeiture values for all contracts issued under a plan of insurance to be determined using 1980 or 2001 CSO Gender-Blended Mortality tables, then the applicable charges of such tables are treated as reasonable mortality charges for female insureds, provided the same tables are used to determine mortality charges for male insureds. Similarly, if a state permits minimum nonforfeiture values for all contracts issued under a plan of insurance to be determined using 1980 or 2001 CSO Smoker and Nonsmoker Mortality tables, then the applicable charges of such tables are treated as reasonable mortality charges for smoker insureds provided nonsmoker tables are used to determine nonsmoker mortality charges. These "anti-whipsaw" rules are similar to those provided in proposed regulations issued in 1991 but never finalized.

## Rules Addressing Changes to Contracts

The last subject addressed by Notice 2004-61 regards identification of the issue date of a contract and the circumstances when a change to the contract — *i.e.*, a so-called material change — will cause it to be considered as newly issued for purposes of applying the notice. In this respect, Notice 2004-61 generally states that the date a contract is considered issued will be determined according to the standards in place at the time of the original effective date of Section 7702, which is also based on the "issue date" of a contract. The Notice elaborates on this in several respects. First, it observes as an example that contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange. The Notice then states as a general rule that a change in an existing contract will not be considered to result in an exchange if the terms of the resulting contract (that is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract and mortality and expense charges) are the same as the terms of the contract prior to the change. These statements have counterparts in Notice 88-128.

Going beyond the 1988 notice, at the urging of the life insurance industry, Notice 2004-61 provides that a contract satisfying one of the 1980 CSO table safe harbors need not begin using the 2001 CSO tables upon a change in benefits if (a) the change, modification or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract, (b) the state in which the contract is issued does not require use of 2001 CSO for such contract under its standard valuation and minimum nonforfeiture laws and (c) the contract continues upon the same policy form or blank. Somewhat departing from the industry's request, Notice 2004-61 further states that the changes, modifications or exercises of contractual provisions referred to include addition or removal of a rider, an increase or decrease in death benefit (if the change is not underwritten), and a change from an option 1 to option 2 contract or vice versa.

## Questions that Have Been Raised

Many of the rules provided by Notice 2004-61 have been favorably received by insurers, particularly those addressing when newly issued contracts would need to begin using the 2001 CSO tables under the safe harbors. A number of questions/issues have arisen, however, with respect to the notice.

## Relationship between first and second safe harbors.

One issue regards the effect, if any, of Notice 2004-61 on the safe harbor rules contained in Notice 88-128. As noted above, Notice 2004-61 states, as its first safe harbor, that the interim rules of Notice 88-128 remain in effect, except as otherwise modified by Notice 2004-61. At the same time, the second safe harbor of Notice 2004-61 sets forth requirements that appear largely the same as those of the 1980 CSO table safe harbor of Notice 88-128, but it adds a requirement that mortality charges

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reflected under section 7702 cannot exceed the mortality charges guaranteed under a contract. Given that this additional requirement was not part of the Notice 88-128 safe harbor, questions have been raised regarding whether this additional requirement constitutes a modification, potentially retroactive, to the Notice 88-128 safe harbor. In other words, when the first safe harbor of Notice 2004-61 states that the rules of Notice 88-128 remain in effect "except as otherwise modified" by Notice 2004-61, did the IRS intend for the requirements of the second safe harbor to constitute such a modification, so that the 1980 CSO table safe harbor of Notice 88-128 would effectively be replaced by the second safe harbor of Notice 2004-61? On its face, Notice 2004-61 does not do this. The description of the second safe harbor in Notice 2004-61 does not in any fashion indicate that it has any relevance to the first safe harbor of this notice. In addition, section 5.02 of Notice 2004-61 refers to the first and second safe harbors as separate safe harbors (which of course they are); it would be odd to do this if the second safe harbor was intended in some manner to replace the first safe harbor. The continuing applicability of Notice 88-128 more generally is shown by the fact that Notice 2004-61 neither includes a safe harbor pertaining to life insurance contracts, that have relied upon the 1958 CSO safe harbor of the earlier notice, nor modifies this safe harbor, in any respect.

**Given the questions that have been raised with respect to Notice 2004-61 and the topics still unaddressed, it seems likely that this notice is just first round by the IRS in clarifying some of the open questions presented by the mortality charge requirement of Section 7702.**

Given that the first and second safe harbors of Notice 2004-61 are, in fact, separate, one may reasonably ask why there is any confusion in the first instance, but there are several reasons why questions have been raised. One such reason is that it is not immediately clear from Notice 2004-61 what modifications have been made to the safe harbor rules of Notice 88-128. As noted above, the first safe harbor of Notice 2004-61 states that the rules of Notice 88-128 continue to apply except as otherwise modified by Notice 2004-61, and, by this statement it seems clear that some such modifications must have been made. However, Notice 2004-61 does not contain any direct statements identifying what such modifications are, nor is any effective date rule for application of such modifications set forth in Notice 2004-61. One possibility in this regard is that the guidance in Notice 2004-61 relating to smoker and gender table variations may represent such modifications. In other words, under the first safe harbor, the rules of Notice 88-128, including allowance of 100 percent of 1980, continues as a valid safe harbor except as modified by the discussion relating to such table variations, which generally allow greater flexibility.

A second reason for confusion regarding the relationship of the first and second safe harbors of Notice 2004-61 is that, if the first safe harbor of Notice 2004-61 continues, the 1980 CSO table safe harbor of Notice 88-128, e.g., as modified by the discussion in Notice 2004-61 regarding gender and smoker table variations, then it becomes somewhat unclear why the second safe harbor of Notice 2004-61 was needed, since it mirrors the requirements of the Notice 88-128 safe harbor, but also adds a new requirement. Since the first and second safe harbors of Notice 2004-61 are largely identical, apart from the additional requirement imposed by the second safe harbor, seemingly no one should ever need to rely on the second safe harbor since they may simply rely on the first safe harbor without concern about the additional requirement imposed by the second safe harbor. If this is so, then one must ask why the IRS felt the need to include the second safe harbor.

The answer may be that the IRS may contemplate that an effective date rule may ultimately be made applicable to the first safe harbor so that it would not be available for newly issued contracts after some future date. In this regard, Notice 88-128 states that its interim safe harbor, allowing use of the 1980 CSO tables, applies to contracts that are issued on or before the date 90 days after the issuance of temporary regulations addressing reasonable mortality charges under section 7702. Notice 2004-61 does not constitute a temporary regulation; however, it may be prefatory to the issuance of such guidance, which may set forth an effective date after which the first safe harbor may no longer be available in its present form. (Some have asked whether the October 12, 2004 publication date of Notice 2004-61 in some manner sunsets the rules of Notice 88-128. This is unclear, although it is perhaps telling that Section 6 of Notice 2004-61, titled "Effect Upon Other Publications," states merely that

"This notice supplements Notice 88-128.") Another possible explanation for the presence of both the first and second safe harbors of Notice 2004-61 may be that, while the second safe harbor may seem unnecessary given the first, there may be some differences that nonetheless exist between them that made inclusion of the second appropriate.

## Underwritten Increases in Benefits

As discussed above, Notice 2004-61 contains a discussion regarding changes to a contract that will cause it to be treated as newly issued for purposes of applying the notice. In this regard, Notice 2004-61 states that, if certain requirements are satisfied, then a change, modification or exercise of a right to modify, add or delete benefits pursuant to the terms of a contract will not cause such contract to be treated as newly issued. The notice then goes on to list some examples, stating that the changes, modifications or exercises of contractual provisions referred to include addition or removal of a rider, an increase or decrease in death benefit (if the change is not underwritten), and a change from an option 1 to option 2 contract or vice versa. Some questions have been made about the purpose of the parenthetical, and particularly whether it implicitly stands for the proposition that an underwritten change in benefits does cause a contract to be treated as newly issued.

At present, the precise import of Notice 2004-61 for underwritten benefit increases is unclear, but it is important to note that the sentence in question that contains the parenthetical about nonunderwritten increases is simply a list of examples of types of changes that do not cause a contract to be treated as newly issued. The sentence, by using the word "include," is not purporting to set forth a comprehensive list. Also, if the IRS had intended that all underwritten increases would cause a contract to be treated as newly issued, the IRS could have added a sentence to this effect, and one might expect that it would have done so, given that underwritten increases are one of the most common kinds of changes contracts experience and the proper treatment of such increases has been a source of much discussion since the enactment of the present version of Section 7702(c)(3)(B)(i) in 1988. At a conference, sponsored by the Society of Actuaries last fall, representatives of the IRS made informal comments that are consistent with the above analysis, i.e., that the sentence containing the reference to nonunderwritten increases is illustrative, rather than comprehensive, and that there was no intention to imply that all underwritten increases would cause a contract to be treated as newly issued. At the same time, these representatives observed that some underwritten increases may be so material relative to the pre-change contract that they would result in a deemed new issuance of the contract. No clear line exists at present to distinguish underwritten increases that have the one treatment versus the other, although it seems fair to say that underwritten increases that are in no way extraordinary relative to those commonly made by owners of life insurance policies, probably should not cause a contract to be treated as newly issued for purposes of applying Notice 2004-61.

## Request for Comments and Future Actions

Notice 2004-61 requested comments from taxpayers, which were due on January 10, 2005, regarding guidance needed to address issues not specifically addressed by this notice or Notice 88-128, including issues addressed by section 1.7702-1 of the proposed regulations issued in 1991. The American Council of Life Insurers, the principal life insurance industry trade association, has submitted comments and requested guidance with respect to, among other things, the treatment of life insurance contracts insuring multiple lives and substandard risks and regarding how to account for the fact that the 2001 CSO tables have extended the terminal age to 121, whereas section 7702 requires the assumption of a maturity date no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Given the questions that have been raised with respect to Notice 2004-61 and the topics still unaddressed, it seems likely that this notice is just the first round by the IRS in clarifying some of the open questions presented by the mortality charge requirement of Section 7702. □

*John T. Adney is a partner with the Washington, DC law firm of Davis & Harman LLP, and may be reached at* jtadney@davis-harman.com.

*Craig R. Springfield is a partner with the Washington, DC law firm of Davis & Harman LLP, and may be reached at* crspringfield@davis-harman.com.