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Alternative XXX Model Regulations from a Federal Income Tax Perspective

by James Reiskytl

Anytime anyone proposes new select factors for the existing generally recognized mortality table — the 1980 CSO table — the life insurance industry must be concerned about both its potential tax impact on the definition of life insurance and on reserve deductions.

The definition of life insurance affects every permanent plan of insurance sold by the industry, under section 7702 of the tax code. Any change in reserve deductions, under section 807, is effective after the new table has been adopted by 26 states. Today, reasonable mortality charges used in the definition of life insurance are based on the 1980 CSO table without select factors.

As discussed in the remainder of this article, in our opinion, these concerns have been successfully addressed and dealt with in the newly revised Alternative XXX model regulations.

Background

At its May 1998 Meeting, the ACLI Board of Directors had approved support of the proposed XXX Alternative subject to satisfactory resolution of specified ancillary issues — one of which was federal taxes.

An ad hoc industry group was formed, chaired by Jim Reiskytl and Armand dePalo, to revise the select factors or limit their use, if necessary, so as to satisfactorily address the tax issues. The tax working group would interact with the Actuarial Valuation Working Group to hopefully find an acceptable solution from both valuation and tax perspectives.

The primary products affected are level premium term insurance and universal life policies with secondary premium guarantees. The alternative proposal had to cover both basic reserves and deficiency reserves. The time frame was very tight. The tax group's goal was to determine alternative choices that would be almost universally supported by tax professionals by the end of July 1998.

Tax Ad Hoc Working Group

Three teams were formed. The first, chaired by Frank McCarthy, was to build a model for the industry to test any alternatives recommended or suggested to determine if the mortality table "generally yields the lowest reserves" as required by section 807(d)(5)(E). This team was also to gather industry data (sales and lapse rates by gender, age, product) from LIMRA and an ACLI intercompany survey.

Team 2, chaired by Jim Lodermeier, developed alternatives to the original proposed table of 25-year select factors that would not (working with the Team 1 model) produce generally lower reserves than those using the 1980 CSO aggregate mortality table. Team 2 was not to be inhibited by the likely impact or acceptability of the new select factors. Its goal was to mathematically create as many options as possible. Options considered included shortening the select period, increasing the select factors, changing the slope of the select factors, redoing the grade into the 1980 CSO table and other variations, including combinations of the above.

The third team, chaired by Ed Robbins, considered various ways of limiting the usage of the new select factors to only certain plans of individual insurance, such as those without guaranteed nonforfeiture factors. They also were to consider companies using alternative possibly nondeductible reserves.

The project proceeded swiftly. Each team reported on their progress weekly for five weeks and completed their work as planned by July 31. Many contributed to these efforts. Especially noteworthy were Art Panighetti's efforts in measuring the reserve impact of various alternatives. After a series of discussions between the tax and valuation working groups, the select factors were fine-tuned any number of times. Ultimately, a recommendation that met various practical valuation objectives, as well as not changing the tax definition of life insurance, was successfully developed.

Conclusions

The revised XXX Alternative incorporates improved mortality projected to about 2000. Basic reserves will be based on the 1980 CSO tables with new 15-year select factors that grade over the next five years (20 total) to the 1980 CSO rates. The table is further limited to the full 1980 CSO rates with or without 10-year select factors at attained age 70 and above. Testing of this table confirmed that the 1980 CSO table without select factors will continue to yield the lowest reserves overall so this table will continue to be the "prevailing mortality table." This testing was done based on a present value of the change in the reserve amounts for a single year of issue at representative issue ages based on industry wide data and standards.

Deficiency reserves will be based on individual company mortality results, updated annually by the corporate valuation actuary, and as such is unlikely to have any tax effect.

Regulations defining reasonable mortality charges used in the life insurance definitional tests under code section 7702 have never been finalized. Notice 88-128 and the proposed regulations published in 1991 provide a safe harbor for rates that do not exceed those of the 1980 CSO table. The XXX Alternative is in our view wholly compatible with this safe harbor and that coupled with the other advantages of the new table, warrant proceeding with the revised XXX Alternative at this time.

One final observation, mortality has improved significantly. As a result of this improvement, it is probably time to begin development of the 2000 CSO mortality tables.

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