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Time to Say Goodbye to the 1980 CSO Mortality Table

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In the race towards a new mortality table, the finish line is coming up fast. At the finish, the new 2001 CSO Mortality Table will be crowned victorious, at least for a while, and the 1980 CSO will be a table of the past. As the final lap to the finish begins, companies must ensure that significant and necessary product development, and administrative and compliance system changes, have been completed and tested. All systems must be able to accommodate the new table.

The race towards a new CSO table began in December, 2002, when the National Association of Insurance Commissioners (NAIC) adopted the Model Regulation recognizing the 2001 CSO Mortality Tables. In this first lap, the life insurance industry began what would turn out to be a six-year transition process. The Model Regulation adopted in 2002 recognized the 2001 CSO tables, permitted their use, and prescribed how they shall be used. The Model Regulation also provided a transition period that would allow life insurance companies time to transition products to the new mortality table. That transition period is set to close at the end of this calendar year, on Dec. 31, 2008. All 50 states have now adopted the Model Regulation. Thus, beginning Jan. 1, 2009, all life insurance products sold in the United States must satisfy both the state minimum nonforfeiture law requirements and the state minimum reserve requirements using 2001 CSO mortality.

Since 2002, there have been SOA-sponsored seminars dedicated to the 2001 CSO tables, countless sessions at SOA meetings, and numerous articles written that address the implications of adopting a new CSO mortality table. In addition, clarity has been brought to a number of issues through published guidance from the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury). This is well and good, since the final lap is underway and the finish line is in sight. (And as discussed below, the finish line is already here in some respects.) For some companies, the race is complete, as their portfolios have successfully been converted and their administrative systems have been successfully modified to support the 2001 CSO tables. Others are hastily working toward achieving this goal. This article is intended to provide a checklist to help those navigating through the final hurdles of their efforts to implement the change to the 2001 CSO tables, focusing on the key dates and transition issues that will effectively sunset the 1980 CSO tables, and also on points to consider to ensure ongoing product tax compliance for 2001 CSO products.

Section 807 Tax Reserves

As a general matter and as stated above, beginning Jan. 1, 2009, all life insurance products sold in the United States must satisfy both the state minimum nonforfeiture law requirements and the state minimum reserve requirements using 2001 CSO mortality. From that point forward, reserves on both a statutory and tax basis must be based on 2001 CSO mortality. However, use of 2001 CSO is required in other instances as well.

According to section 807 of the Internal Revenue Code (Code), tax reserves are the greater of (1) the net surrender value of the contract, or (2) the reserve computed under federally prescribed standards (*i.e.,* the "Federally Prescribed Tax Reserves," or FPTR). In no event, however, can tax reserves exceed statutory reserves. The FPTR is the reserve determined by using (a) the tax reserve method applicable to such contracts, (b) the greater of the applicable Federal interest rate or the prevailing State assumed rate, and (c) ***the prevailing Commissioners' Standard Table*** for mortality adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

When section 807 was created, Congress had the foresight to build-in transition rules to address the adoption of a new prevailing table. These transition rules allow for the use of both the "old" and the "new" tables for a

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period of three calendar years that begins on January 1 of the year (referred to in section 807(d)(5)(B) as the "year of change") that follows the year when a new prevailing table arises. Since the 2001 CSO tables became the ***prevailing Commissioners' Standard Table*** during 2004 following the adoption of the Model Regulation by the 26th state, the mortality tables' "year of change" was 2005, and thus the 1980 CSO tables continued to be permitted for use as the prevailing tables under section 807 until after "the three-year period beginning with the first day of the year of change," *i.e.,* through Dec. 31, 2007. Thus, beginning Jan. 1, 2008, the 2001 CSO became the required table for use in computing reserves for tax purposes. However, it is not until Jan. 1, 2009 that the 2001 CSO will become the required table for state minimum nonforfeiture values. Companies should be aware of this 12-month differential and recognize that tax reserves for 1980 CSO products issued in 2008 must be based on 2001 CSO mortality.

Section 7702(c)(3)(B)—Reasonable Mortality Requirements

Both sections 7702 and 7702A of the Code impose funding limitations on life insurance contracts. Companies must insure that contracts are administered within these funding limitations so that the life insurance contracts retain their favorable tax treatment. These limitations place restrictions on both the allowable premiums paid into a life insurance contract and the allowable cash value for a given death benefit. In defining these actuarial limitations, section 7702(c)(3)(B)(i) requires the mortality used to be "reasonable." While not directly defining the term reasonable, section 7702(c)(3)(B)(i) goes on to additionally require that the mortality charges assumed must 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."

The reasonable mortality charge requirement is tied to the ***prevailing Commissioners' Standard Tables*** as defined in section 807(d)(5). As previously discussed above, the 2001 CSO tables became "prevailing" during 2004, starting the clock on a three-year transition period, ending Dec. 31, 2007, during which both the 1980 and 2001 CSO tables would be considered prevailing tables. Assuming the three-year transition period provided in section 807 carries over to section 7702, use of the 2001 CSO tables would be required for contracts issued after Dec. 31, 2007, which could create difficulties for 1980 CSO contracts with respect to satisfying the reasonable mortality requirements of section 7702.[1]

To alleviate some of this uncertainty, the IRS issued Notice 2006-95[2] (released in October 2006), which provides guidance on the transition to the 2001 CSO tables for purposes of satisfying section 7702's reasonable mortality requirement. More specifically, Notice 2006-95 provides for "safe-harbors" with respect to the reasonable mortality charge requirements of section 7702(c)(3)(B)(i). By meeting one of these safe harbors, companies can be assured that their life insurance contracts will satisfy section 7702's reasonable mortality requirements.

- Notice 88-128 Safe Harbor: Notice 2006-95 provides that the interim rules described in Notice 88-128 remain in effect, except as modified by Notice 2006-95.

- 1980 CSO Safe Harbor: A mortality charge with respect to a life insurance contract will satisfy the requirements of section 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables; (2) the contract is issued in a state that permits or requires the use of the 1980 CSO tables at the time the contract is issued; and (3) the contract is issued before Jan. 1, 2009. It appears critical that 1980 CSO contracts meet this safe harbor or the Notice 88-128 Safe Harbor if they are issued during 2008 and cover a standard risk insured, since it may not otherwise be possible for such designs to comply with the statute. This is because calculations under sections 7702 and 7702A for such a contract not meeting one of these safe harbors would need to use 2001 CSO mortality.

[1] The potential exists for state law minimum cash values (nonforfeiture values) to exceed federal maximums for traditional whole life contract designs that are intended to comply with the cash value accumulation test of section 7702(a)(1).

[2] Notice 2006-95 supplements Notice 88-128, 1988-2 C.B. 540, and modifies and supersedes Notice 2004-61, 2004-2 C.B. 596. Notice 2004-61 also addressed the transition to the 2001 CSO tables.

- 2001 CSO Safe Harbor: A mortality charge with respect to a life insurance contract will satisfy the requirements of section 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after Dec. 31, 2008, or (b) the contract is issued before Jan. 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued.

While Notice 2006-95 provides safe harbors for both 1980 and 2001 CSO products, an important distinction exists in how the safe harbors are defined. For life insurance products designed to comply with the 2001 CSO Safe Harbor, companies will need to consider whether the contract in some way guarantees mortality charges that are less than 100 percent of the 2001 CSO tables (*e.g.*, guarantying "current" mortality rates for the first year). If so, it would be necessary to reflect these lower rates in the calculations under sections 7702 and 7702A in order to meet the safe harbor requirements for this table. A similar requirement does not exist with respect to the 1980 CSO safe harbors.

Maturity Date Implications of the 2001 CSO Mortality Tables

There are several characteristics of the 2001 CSO tables that distinguish it from prior CSO tables, most notably a 25-year select period and the extension of the table beyond age 100. These raise some fundamental questions regarding how calculations should be made for such contracts under sections 7702 and 7702A.

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> Can benefits beyond age 100 be reflected in the calculation of guideline, net single and 7-pay premiums?
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> Is the application of the guideline premium test limited by the assumptions underlying the calculation of the premiums themselves?
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> Can a company assume the Section 7702(d) corridor factors extend to age 120?
>
> How should the cash value accumulation test be administered beyond age 100?

These questions are linked to the computational rules of section 7702(e)(1), which limit future benefits that can be incorporated into the calculation of guideline, net single, and 7-pay premiums. In particular, section 7702(e)(1)(B) provides that the maturity date assumed in the calculation can be 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.

The insurance industry has requested guidance from Treasury and the IRS on the proper application of the current computational rules to the 2001 CSO Mortality Table but, to date, such guidance has not been provided. To help companies deal with the uncertainty created from the structure of the 2001 CSO tables, the Taxation Section of the Society of Actuaries established the ***2001 CSO Maturity Age Task Force***. The purpose of the task force was to propose methodologies that would be actuarially acceptable under sections 7702 and 7702A for calculations under contracts that do not provide for an actual maturity before age 100.[3] The recommendations put forth by the 2001 CSO Maturity Age Task Force are as follows:

- Calculations will assume that all contracts will pay out in some form by age 100, as presently required by the Code, rather than by age 121 as would occur "naturally" under the 2001 CSO.
- The net single premium used in the cash value accumulation test corridor factors, of section 7702(b), and the necessary premium calculations, of section 7702A(c)(3)(B)(i), will be for an endowment at age 100.

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[3] While these recommendations do not represent formal guidance with respect to establishing compliance with the section 7702 and 7702A requirements, they do provide insight as to how companies are modifying their administration systems to support the 2001 CSO tables.

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- The guideline level premium present value of future premium calculations, of section 7702(c)(4), will assume premium payments through attained age 99.

- The sum of guideline level premiums, of section 7702(c)(2)(B), will continue to increase through attained age 99. Thereafter, premium payments will be allowed and will be tested against this limit, but the sum of guideline level premiums will not increase. If the guideline level premium is negative, the sum of guideline level premiums will also not decrease after age 99.

- In the case of contracts issued or materially changed near to the insured's age 100, the modified endowment contract (MEC) present value of future premium calculations will assume premium payments for the lesser of seven years or through age 99. This is the case because the computational rules of section 7702A(c)(1) provide: "Except as provided in this subsection, the determination under subsection (b) of the 7 level annual premiums shall be made … by applying the rules … of section 7702(e)," suggesting a need for a new seven-pay premium. However, since section 7702(e)(1)(B) requires a maturity date of no later than the insured's attained age 100, it arguably overrides the computational rules of section 7702A(c)(1) and thus the calculations would end at age 100. Given the lack of guidance, reasonable alternative interpretations may also be available on this point.

- If the MEC present value of future premium calculations assumes premium payments through age 99 but this is less than seven years, the sum of the MEC premiums will continue to increase through attained age 99. Thereafter, premium payments will be allowed and will be tested against this limit for the remainder of the seven-year period, but the sum of MEC premiums will not increase after age 99.

- In the case of contracts issued or materially changed near to the insured's age 100, followed by a reduction in benefits, the MEC reduction rule, of section 7702A(c)(2), will apply for seven years from the date of issue or the date of the material change for a single life contract. For contracts insuring more than one life, the MEC reduction rule, of section 7702A(c)(6), will apply until the youngest insured attains age 121.

- Adjustments that occur on or after attained age 100 will not necessitate a material change for MEC testing purposes or an adjustment event for guideline premium purposes.

- Necessary premium/deemed cash value testing, of section 7702A(c)(3)(B)(i), will cease at attained age 100.

- Policies can remain in force after age 100 with a death benefit greater than or equal to the cash value.

The 2001 CSO and Attained Age Regulation §1.7702-2

In September 2006, Treasury and the IRS issued final regulations providing guidance on the determination of an insured's "attained age" for certain purposes under sections 7702 and 7702A. The regulations became effective Sept. 13, 2006 and apply to policies either (a) issued after Dec. 31, 2008, or (b) issued on or after Oct. 1, 2007 and based on the 2001 CSO tables. A taxpayer may choose to apply the final regulations to policies issued prior to Oct. 1, 2007 provided that the taxpayer does not later determine the policies' qualification in a manner that conflicts with the regulations. The effective dates of this regulation were intentionally designed to coincide with the 2001 CSO effective dates contained in the NAIC's Model Regulation so as to coordinate with state filings and changes in compliance systems needed due to both the new attained age rules and the transition to the 2001 CSO tables.

However, guidance contained in the regulation imposes requirements, applicable for certain purposes, that run contrary to how certain life insurance companies design and administer their contracts. In particular, under these requirements, companies cannot use derived ages for multiple life contracts. This would include the use of a "joint equal age" for contracts insuring more than one life and the use of a "rated age" to reflect a substandard mortality risk associated with a particular insured. These requirements, on their face, apply for purposes of section 7702(c)(4), which relates to the guideline level premium, section 7702(d), which relates to the cash value corridor requirement, and section 7702(e), which relates to computational rules (including the rule requiring that the deemed maturity date assumed be no earlier than the insured's age 95 and no later than the insured's age 100).

A second issue affects the administration of off-anniversary changes. The final regulations state that: *"Once determined, … the attained age with respect to an individual insured under a contract changes annually."* [4] (Emphasis added.) This approach runs contrary to a common insurance industry practice with regard to off-anniversary death benefit increases. Many administrative systems apply a "segment approach" to death benefit increases, where each segment, or layer, of additional death benefit is administered independently from the base contract. Each segment is assigned its own issue date, coverage amount, issue age, etc., and the system calculates guideline premiums according to the characteristics assigned to each segment. Under a segment approach, the system would aggregate guideline or net single premiums for each segment to determine the premiums applicable to the contract. Also, administration systems are commonly programmed to determine issue age for the segment as if the segment were viewed as a newly issued contract. If the contract defines age on an age-last-birthday basis, the segment issue age would be determined on an age-last-birthday basis as of the segment effective date. Thus, the segment issue age under an age-last-birthday determination may be greater than the attained age permitted under the final regulations, resulting in a potential overstatement of guideline or net single premiums.

In addition, section 7702A(c)(3)(A)(i) material changes create a rather odd tension with the "attained age" rules contained in this regulation. Upon a material change in benefits under a contract which was not reflected in any

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previous determination under section 7702A, section 7702A(c)(3)(A)(i) requires the contract to be treated as "a new contract entered into on the day on which such material change takes effect." How does this language reconcile with the language in the regulation that states that age, once determined, changes annually? Could it be that there is a different attained age for section 7702A calculations than for section 7702 calculations? Let's look at an example:

> *Example:* An insured born on May 1, 1947 purchases a policy on Jan. 1, 2008. January 1 is the contract anniversary date for future years. The face amount of the contract is increased on May 15, 2011. During the contract year beginning Jan. 1, 2011, the age assumed under the contract on an age-last-birthday basis is 63 years. However, at the time of the face amount increase the insured's actual age is 64. Treas. Reg. section 1.7702-2(b)(2) provides that, once the attained age is determined, it remains that age until the next policy anniversary. Thus, the insured continues to be 63 years old throughout the contract year beginning Jan. 1, 2011 for purposes of sections 7702(c)(4), 7702(d) and 7702(e), as applicable, even though the insured is age 64 at the time of the increase based on an age-last-birthday determination.

Under this example, if the contract is considered newly entered into on the date of the face amount increase (May 15, 2011), is it then appropriate to determine age as if the contract were newly entered into on that date for purposes of section 7702A(c)(3)(A)? It would seem so, in which case the attained age for the 7-pay premium calculation in the example is 64. While calculations of 7-pay premiums under section 7702A are made, in part, using the computational rules of section 7702(e), section 7702A(c)(3)(A)(i) appears to be the more specific statutory rule governing the date when calculations are made and an insured's age is identified for purposes of the

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[4] Section 1.7702-2.

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section 7702A(c)(3) material change rule. Additional guidance on this issue would be helpful.

Final Thoughts

These are just some of the implications facing companies as they enter this final lap in the race to the new 2001 CSO tables. Much of what is written here summarizes articles previously published in *Taxing Times*, including:

> *Evolution of the Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code,* Christian DesRochers (May 2005, Vol. 1 Issue 1)
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> *2001 CSO Implementation Under Sections 7702 and 7702A, the 2001 CSO Maturity Age Task Force,* (May 2006, Vol. 2 Issue 1)
>
> *More on Reasonable Mortality: IRS Issues Notice 2006-95,* Brian G. King, John T. Adney and Craig R. Springfield, (Feb. 2007, Vol. 3 Issue 1)
>
> *Age Defined: IRS Issues Final Regulations on "Attained Age" Under Section 7702*, Brian G. King, John T. Adney and Craig R. Springfield, (May 2007, Vol. 3 Issue 2)

Readers should revisit these previously published articles for a more in-depth discussion on these topics.[5] The finish line is rapidly approaching. It's time to bid a fond farewell to the 1980 CSO. System modifications necessary to support the new requirements must be tested and implemented. The 2001 CSO is here. Are you ready?

[5] Prior issues of *Taxing Times* can be viewed on-line by visiting the Taxation Section webpage on the Society of Actuaries Web site at *www.soa.org.*