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NAIC Proposal for Mortality Under Pre-Need Life Insurance

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The National Association of Insurance Commissioners (NAIC) has exposed for comment a draft model regulation that proposes the establishment of new minimum mortality standards for reserves and non-forfeiture values for pre-need life insurance (the Draft Pre-Need Model or Model). In this article, we first describe certain features of the Draft Pre-Need Model, which has thus far been approved by the Life and Health Actuarial Task Force. After this, we discuss the implications of adoption of the Model in regard to both the so-called federally prescribed reserves under section 807(d) and calculations under sections 7702 and 7702A defining "life insurance contract" and "modified endowment contract," respectively, under the tax law. (The comments in this article relate to the Feb. 7, 2008 draft of the Model.)

The Draft Pre-Need Model

Rule proposed. The Draft Pre-Need Model provides that "for preneed insurance contracts … and similar policies and contracts, the minimum mortality standard for determining reserve liabilities and non-forfeiture values for both male and female insureds shall be the Ultimate 1980 CSO." The Ultimate 1980 CSO, in turn, means the Commissioners' 1980 Standard Ordinary Life Valuation Mortality Tables without 10-year selection factors, as incorporated into the 1980 amendments to the NAIC Standard Valuation Law approved in December 1983 (1980 CSO). The Draft Pre-Need Model contains transition rules, *e.g.*, generally permitting continued use of the 2001 Commissioners' Standard Ordinary Mortality Table (2001 CSO) for pre-need policies issued before Jan. 1, 2012.

Contracts covered. The Pre-Need Model applies only in respect of "preneed insurance contracts," which are defined in the Model as "any life insurance policy or certificate that is issued in combination with, in support of, with an assignment to, or as a guarantee for a prearrangement agreement for goods and services to be provided at the time of and immediately following the death of the insured." In addition, the definition states that the status of a policy or certificate as a "preneed insurance contract" is determined at the time of issue in accordance with the policy form filing. As previously noted, the rule proposed also applies to "similar policies and contracts."

Purpose. The purpose of the Draft Pre-Need Model is described in part in a drafting note set forth in the Model. Specifically, the drafting note observes that research conducted by the Deloitte University of Connecticut Actuarial Center and commissioned by the Society of Actuaries as part of a study of pre-need mortality "determined that the 2001 CSO Mortality Table … produced inadequate reserves for policies issued in support of a prearrangement agreement which provides goods and services at the time of an insured's death."

Effective date. The Draft Pre-Need Model is proposed to be applicable to pre-need insurance policies and certificates and similar contracts and certificates issued on or after Jan. 1, 2009.

Section 807(d)

Section 807(d) sets forth the rules governing the reflection of life insurance reserves for purposes of determining life insurance company taxable income, and, in this regard, section 807(d)(2)(C) provides that the amount of the federally prescribed reserve—the maximum amount of the deductible reserve for a contract, unless the contract's net surrender value is greater—is determined using, *inter alia*, the "prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account." Section 807(d)(5)(A), in turn, states that "the term 'prevailing commissioners' standard tables' means, with respect to any contract, the most recent commissioners' standard tables prescribed by the [NAIC] which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued."

If the Draft Pre-Need Model is adopted by the NAIC, and then adopted by at least 26 states, 1980 CSO would, subject to the following discussion regarding transition rules, constitute the prevailing commissioners' standard tables for pre-need contracts issued on or after the date of the adoption of the Model by the 26th state. At present, the 2001 CSO tables are the prevailing commissioners' standard tables under section 807(d) for all life insurance contracts, including pre-need contracts. Thus, adoption of the Model by the NAIC and 26 states would undo the effect of the adoption of 2001 CSO for pre-need contracts—an unprecedented step as far as section 807(d) is concerned. In considering the scope of the proposed change, one issue regards the meaning of the term "preneed insurance contract" as set forth in the Model. The-Model includes a definition of this term, which is helpful. At the same time, the Model's operative rule—requiring use of 1980 CSO—states that it also applies to "similar policies and contracts," which is less clear.

In defining the "prevailing commissioners' standard tables," section 807(d)(5)(B) provides for transitional relief, allowing insurance companies to continue to treat a table as prevailing during the three-year period following the year during which a new table is approved by the 26th state. Thus, for example, if the Model, as prescribed by the NAIC, was adopted by the 26th state during 2009, it would be permissible to continue to use 2001 CSO for pre-need contracts issued during 2010-2012. On closer analysis, there may be some question about the interrelationship between the three-year transition rule and the basic rule of section 807(d)(5)(A) set forth above. On the one hand, this three-year transition rule is permissive, since section 807(d)(5)(B) states that an insurance company "may" apply the three-year rule and, conversely, seemingly could choose not to apply such rule (*i.e.*, an insurance company could choose to apply the Model and 1980 CSO for pre-need contracts issued on and after the date of the approval of the Model by the 26th state, assuming this is after the effective date of the Model).

Thus, 2001 CSO is currently the prevailing table for contracts issued beginning Jan. 1, 2008.

On the other hand, one question that would need to be addressed is whether the transition rule set forth in the Draft Pre-Need Model affects the identification of the "most recent" commissioners' standard mortality tables "permitted to be used in computing reserves for that type of contract" for purposes of section 807(d)(5)(A). If it does, then 2001 CSO—being more recent than 1980 CSO, based on the dates when the tables were developed—may constitute the prevailing commissioners' standard tables during such transition period, and it therefore may not be permissible to use 1980 CSO during the Model's transition period. Alternatively, the date of adoption by the NAIC of a particular commissioners' standard tables for a type of contract may control for purposes of determining the mortality table that is most recent. This issue has not arisen before, as there has not been a reversion to a prior mortality table during the nearly quarter-century history of section 807(d). (It would seem that this technical issue might be avoided—or at least that the issues might be lessened—if the NAIC defined a new mortality table, perhaps called the "2009 Pre-Need Mortality Table," to apply to pre-need contracts, even if such table was equivalent to 1980 CSO.)

Another consideration regards how to treat pre-need contracts issued from Jan. 1, 2008 through the date when 1980 CSO becomes the prevailing table for such contracts for purposes of section 807(d). Because 2001 CSO was adopted by the 26th state during 2004, the three-year transition period described above, which permitted continued use of 1980 CSO, ended on Dec. 31, 2007. Thus, 2001 CSO is currently the prevailing table for contracts issued beginning Jan. 1, 2008. This is somewhat anomalous in view of the finding re-

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flected by the drafting note contained in the Draft Pre-Need Model that "… the 2001 CSO Mortality Table … produced inadequate reserves for policies issued in support of a prearrangement agreement which provides goods and services at the time of an insured's death."

At this time, it is not clear how this anomaly should be reconciled with the statutory rules. One suggestion that has been made is that, in circumstances where an insurer applies 1980 CSO for such contracts for statutory reserving purposes, section 807(d)(2)(C) already includes a mechanism to reflect 1980 CSO—specifically, the language in this rule permitting reflection of the prevailing commissioners' standard tables for mortality "adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account." In effect, a known attribute of pre-need contracts—*i.e.*, that they are purchased in connection with a prearrangement agreement for goods and services to be provided at the time of and immediately following the death of the insured—would be viewed as a circumstance similar to an underwriting record evidencing a substandard risk that justifies an adjustment to the prevailing mortality tables under section 807(d)(2)(C).

If a pre-need contract is issued with guarantees based on 2001 CSO (*e.g.*, because the contract was issued in a state that had not adopted the Model), but 1980 CSO comes to represent the prevailing commissioners' standard tables under section 807(d), it seemingly would be permissible to reflect 1980 CSO in determining the federally prescribed reserves for the contract under section 807. However, in such instances, the rule in section 807(d)(1)—generally limiting the reserve deduction for any contract to an amount not in excess of the amount taken into account for the contract in determining statutory (annual statement) reserves—often would be applicable.

Sections 7702 and 7702A

For federal tax purposes, section 7702 defines a "life insurance contract" and section 7702A defines a "modified endowment contract." Similar to the discussion of reserves above, the determination of guideline premiums, net single premiums and 7-pay premiums under these provisions is in part made on the basis of a mortality charge assumption. More specifically, section 7702(c)(3)(B)(i)—which directly or by cross reference generally governs for these purposes—states that the calculations 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."

By cross-referencing section 807(d)(5), section 7702 generally permits use of the same mortality assumption as permitted to be reflected in calculating the federally prescribed reserves, as described above. Thus, if the Draft Pre-Need Model is adopted by the NAIC, and then is further adopted by at least 26 states, 1980 CSO would appear to constitute the prevailing commissioners' standard tables for purposes of sections 7702 and 7702A, subject to the discussion above regarding the Model's transition rules. In considering the effect of the Model on calculations under sections 7702 and 7702A, it is necessary to take account of the effect, if any, of the various notices and other guidance that the Internal Revenue Service ("IRS") has issued on mortality, *e.g.*, Notice 2006-95. Significantly, the notices establish safe harbors that are available to all life insurance contracts, including pre-need contracts, *i.e.*, if the conditions to application of a safe harbor are satisfied, the assumption made with respect to mortality will be deemed to meet the requirements of section 7702(c)(3)(B)(i). None of the safe harbors described in the notices, however, will apply to allow use of 1980 CSO for a contract issued after Dec. 31, 2008. Thus, subject to the discussion in the next paragraph, if 1980 CSO is desired to be used for such a contract's section 7702 and 7702A calculations, it generally will be necessary to rely on the statutory rule in section 7702(c)(3)(B)(i) as the sole governing authority. (In light of the reference to "reasonable mortality charges," there is necessarily some uncertainty regarding the scope of this rule.)

Reflection of mortality higher than 2001 CSO may be justifiable after 2008 for reasons similar to the discussion above relating to the adjustment language of section 807(d)(2)(C). In particular, where a contract's guarantees are based on 1980 CSO mortality, it may be appropriate to reflect 1980 CSO in calculations under sections 7702 and 7702A based on section 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (the TAMRA Interim Rule), which views mortality charges as meeting the requirements of section 7702(c)(3)(B)(i) where such charges "do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware)." In some cases (*e.g.*, or-

dinary whole life insurance contracts), the applicable cash values may always reflect guaranteed mortality charges, *i.e.*, they would be imposed in full and thus use of such charges would not seem to differ in any respect from the charges expected to be imposed. The scope of the TAMRA Interim Rule is unclear, *e.g.*, regarding whether knowledge that a contract is a pre-need contract would be viewed as defining a relevant characteristic of the insured of which the company is aware for purposes of this rule.

As a final point, we note that section 7702(e)(2)(C) permits reflection of death benefit increases in the calculation of net single premiums under the cash value accumulation test if certain conditions are met and the contract "was purchased to cover payment of burial expenses or in connection with prearranged funeral expenses." This rule, and also use of 1980 CSO—relative to 2001 CSO—generally have the effect of increasing net single premiums, and thus the permissible cash values, under such contracts. At the same time, the stated purpose of the Draft Pre-Need Model seems to be the overarching consideration in support of use of the new Model and 1980 CSO—*i.e.*, 2001 CSO produces inadequate reserves for pre-need contracts, and it is believed that a move to 1980 CSO is necessary to correct this problem. It is also worth noting that the tax law generally permits the continued use of 1980 CSO for life insurance contracts issued through the end of 2008 where the mortality guarantees of such contracts are based on 1980 CSO. Thus, the Model, once it is effective to define the prevailing commissioners' standard tables for pre-need contracts, will allow use of the same mortality assumption that is permitted today.

Thus, the Model, once it is effective to define the prevailing commissioners' standard tables for pre-need contracts, will allow use of the same mortality assumption that is permitted today.

Conclusion

The adoption of special commissioners' standard mortality tables for pre-need contracts by the NAIC and at least 26 states will have important consequences for both reserve deductions and calculations under sections 7702 and 7702A for such contracts. It will be interesting to see how this unfolds, in view of the unprecedented nature of this step, and given its consequences for contract design, systems and taxes. As a draft, the Model is still undergoing review within the NAIC process. Stay tuned!

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