SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2005 – Volume 1, No. 1

SOCIETY OF ACTUARIES

TAXING TIMES

NEWSLETTER OF THE TAXATION SECTION VOL. 1 ISSUE 1 MAY 2005

Evolution of the Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code

Christian DesRochers

Notice 2004-61[1] is the latest in a series of administrative pronouncements from the Internal Revenue Service related to the appropriate mortality assumptions to be used in computing the definitional limitations under Internal Revenue Code Section 7702 and the seven-pay limitation under the Section 7702A modified endowment rules. Specifically, Notice 2004-61 deals with the transition from the 1980 Commissioners' Standard Ordinary Table (1980 CSO) to the 2001 Commissioners' Standard Ordinary Table (2001 CSO) in determining whether mortality charges are reasonable as defined in Section 7702(c)(3)(B)(i). The notice clarifies the effective date requirements of the 2001 CSO, but also provides some additional guidance on issues related to the 1980 CSO. The requirements of the notice can best be appreciated in the context of the evolution of the mortality requirements under Sections 7702 and 7702A, as it represents another installment in the discussion between the life insurance industry and the Internal Revenue Service over mortality issues.

Background

"Reasonable" Mortality

As enacted in 1984, Section 7702 permitted the recognition of contractually guaranteed mortality charges in the calculation of the guideline premium limitation or the net single premium under the cash value accumulation test. In 1988, as a part of the modified endowment legislation, the Congress added a requirement under Section 7702(c)(3)(B)(i) for contracts issued on or after October 21, 1988, limiting the mortality charges that could be reflected in computations under the statute to those that are reasonable.

The mortality requirement consists of two elements: a *permanent rule* and an *interim rule*. The *permanent rule* refers to the specific statutory language in Section 7702(c)(3)(B)(i). While requiring that mortality charges used in section 7702 (and 7702A) be "reasonable," the statute fails to provide any guidance on how reasonability might be determined, instead delegating that task to the IRS through regulations. However, the *permanent rule* imposes a limitation that, absent an exception provided in regulations, reasonable mortality cannot exceed the rates in the prevailing commissioners' standard table at the time the contract is issued.

The concept of the prevailing table was borrowed from the rules in life insurance company taxation governing the deductibility of life

4

[1] 2004-4 I.R. B. 596, (October 12, 2004).

contents

Evolution of the Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code
Christian DesRochers 1

From the Editor
Brian G. King 2

From the Chair
Edward L. Robbins 3

T^3: Taxing Times Tidbits
Peter H. Winslow and Susan J. Hotine 8

Taxation of Distributions
Douglas Hertz 12

Revenue Ruling 2005-6: Guidance on QABs Under IRC Sections 7702 and 7702A
John T. Adney, Joseph F. McKeever III and Craig R. Springfield 14

Book Review
Life Insurance & Modified Endowments under Internal Revenue Code Sections 7702 and 7702A
Tom Quinn 19

Actuaries
The Best-Kept Secret in Business™

from pg. 1

insurance reserves. Under section 807(d)(5), the prevailing commissioners' standard table is the most recent commissioners' standard table prescribed by the National Association of Insurance Commissioners (NAIC), which is 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. The rules applicable to life insurance company taxation use the prevailing table to limit the mortality that may be assumed in the computation of deductible life insurance reserves.

At the time the reasonable mortality standards were added to section 7702, the 1980 CSO was the prevailing commissioners' standard table[2]. Therefore, under the *permanent rule*, 100 percent of the sex-distinct 1980 CSO Tables generally provided an upper bound on reasonable mortality. Adopted by the NAIC in December 2002, the 2001 CSO has replaced the 1980 CSO as the most recent standard table prescribed by the NAIC. Subsequently, it became the prevailing table in July 2004 after adoption by 26 states.

Section 5011(c)(1) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) directed the Secretary of the Treasury to issue regulations under Section 7702(c)(3)(B)(i) by January 1, 1990, setting forth standards for determining the reasonableness of assumed mortality charges. In response, proposed regulations were issued in 1991, as discussed below, although the U.S.Treasury Department has yet to issue final regulations. Consequently, the *permanent rule* simply limits assumed mortality charges to the prevailing commissioners' standard tables in effect on the issue date of the contract, at least for standard cases. Thus, under the *permanent rule*, mortality is limited to the 2001 CSO Table, subject to a transition rule to determine the effective date. With the change in the prevailing table, guidance on the transition to the 2001 CSO was needed. As will be discussed below, Notice 2004-61 provided that guidance.

In the 1988 legislation, Congress also provided an *interim rule* for contracts issued on or after October 21, 1988, but before the effective date of final regulations.[3] The *interim rule* states that mortality charges, which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristics of the insured of which the company is aware), shall be treated as meeting the requirements of Section 7702(c)(3)(B)(i). As permanent regulations have yet to be issued, the *interim rule* is the currently operative rule.

Notice 88-128

While sounding rather straightforward conceptually, for those actually responsible for computing the limitations, the *interim rule* created a rather vague standard. For contracts with current and guaranteed mortality charges, there was a concern that the *interim rule* required the recognition of the current charges in computing the limitations. In response to the industry's request for guidance, the U.S. Treasury Department issued Notice 88-128,[4] which applies to contracts issued on or after October 21, 1988. Notice 88-128 previewed rules interpreting the reasonable mortality charge requirements, stating that regulations to be published in the future would contain certain provisions. It also provided assurances to the industry regarding ongoing compliance with Section 7702(c)(3)(B)(i) to companies that satisfied the *interim rules* contained in Notice 88-128.

Notice 88-128 generally allows that the use of sex-distinct, aggregate mortality rates under the 1980 CSO Tables is reasonable. The Notice does not define "reasonable mortality," but instead provides that use of certain safe harbor mortality tables will satisfy the requirements of Section 7702(c)(3)(B)(i). The safe harbor mortality table for contracts entered into after October 20, 1988 is 100 percent of the sex-distinct 1980 CSO Tables (consistent with its specification as the prevailing commissioners' table).

Specifically, Notice 88-128 provides that "a mortality charge meets the requirements of Section 7702(c)(3)(B)(i) if such mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables."[5] It does not, however, address the use of the smoker and nonsmoker versions of the 1980 CSO, nor does it appear to provide a safe harbor for the voluntary use of the unisex versions of the table. It goes on to say that, "to the extent that a state requires … [the use of] unisex tables, thereby imposing, for female insureds, mortality charges that exceed the [sex-distinct] 1980 CSO tables, … [the increased mortality charges] may be taken into account with respect to contracts to which that unisex requirement applies."[6]

Christian DesRochers, FSA, MAAA is a senior vice president with Aon Consulting in Avon, Conn. He may be reached at *chris_desrochers@aon. com.*

[2] *Rev. Rul. 87-26, 1987-1 C.B. 158, defines the Commissioners' 1980 Standard Ordinary male or female table, as appropriate, without select factors as the prevailing table.*

[3] *Section 5011(c)(2) of TAMRA.*

[4] *Notice 88-128 1988-2 C.B. 540.*

[5] *Ibid.*

[6] *Ibid.*

The safe harbors provided by Notice 88-128 apply to contracts issued on or before 90 days after the issuance of temporary regulations on reasonable mortality (which the IRS has not issued). The Notice also provides that, if the charges specified in the prevailing commissioners' standard tables exceed the allowable charges under the standards set forth in the regulations, the regulations will apply prospectively to the extent of the excess. This is consistent with the TAMRA legislative history indicating that any "[s]tandards set forth in such regulations that limit mortality charges to amounts less than those specified in the prevailing commissioners' standard tables are to be prospective in application."[7]

...the proposed regulations ... provide some insight into government thinking on the subject at the time that they were proposed, and appear to have served as the model for the safe harbor requirements of Notice 2004-61.

Proposed Regulation Section 1.7702-1

In 1991, several years after the issuance of Notice 88-128, the IRS issued proposed regulations to define reasonable mortality charges for use in computations under Sections 7702 and 7702A. Unlike Notice 88-128, which provided certain safe harbor mortality tables for satisfying the reasonable mortality requirements, the proposed regulations actually defined reasonable mortality. In the proposed regulations, which never have been finalized, reasonable mortality charges were defined to be "those amounts that an insurance company actually expects to impose as consideration for assuming the risk of the insured's death (regardless of the designation used for those charges), taking into account any relevant characteristics of the insured of which the company is aware."[8]

Like the *permanent rule* contained in Section 7702(c)(3)(B)(i), the proposed regulation also placed an upper bound on what constitutes reasonable mortality. In particular, reasonable mortality charges could not exceed the lesser of the mortality charges specified in the prevailing commissioners' standard tables in effect when the contract was issued or the guaranteed mortality charges specified in the contract. This dual limit on "reasonable" mortality would have prevented the use of the prevailing table for those contracts that explicitly guarantee lower mortality charges. In this respect the limitation in the proposed regulations differs from that in Notice 88-128; the Notice does not limit mortality based on the charges in the contract.

The proposed regulations also describe two safe harbors related to the 1980 CSO, under which mortality charges for contracts with only one insured are deemed to be reasonable, as follows:

(1) The use of mortality charges that do not exceed the applicable charges set forth in the 1980 CSO Mortality Table for male or female insureds are reasonable mortality charges; and,

(2) The use of smoker-distinct and gender-blended rates satisfies the safe harbor requirements, if certain conditions are met.

The proposed regulations permitted far greater leeway than Notice 88-128 for single life contracts, subject to a consistency or "anti-whipsaw" rule. For example, 1980 CSO-based mortality rates are deemed to be reasonable if consistently applied within a class of contracts, whether or not distinctions were made according to the insured's sex or tobacco use. Thus, for example, it would not be reasonable, within the same plan of insurance, to use the 1980 CSO aggregate table for nonsmokers and use the smoker table for smokers. Note that this rule implies, but does not specifically state, that 100 percent male mortality is likely not a valid unisex table.

Although issued in 1991, the proposed regulations would have applied to contracts entered into on or after October 21, 1988. This attempt at retroactivity was of no import, however, as the proposed regulations have not been adopted and thus, do not embody legal requirements. They do, however,

[7] *H.R. CONF. REP. NO. 100-1104. pt. 2, at 108 (1998) (the "TAMRA Conference Report").*

[8] *Prop. Treas. Reg. § 1.7702-1(b).*

from pg. 5

provide some insight into government thinking on the subject at the time that they were proposed, and appear to have served as the model for the safe harbor requirements of Notice 2004-61.

Notice 2004-61

Issued in the fall of 2004 in response to the life insurance industry's request for guidance on the transition to the 2001 CSO, Notice 2004-61 provides rules for the transition to the new table. While specifically providing that "rules described in Notice 88-128 remain in effect, except as modified by this notice," it also provides safe harbors that relate to the 1980 CSO, incorporating some concepts that were found in the proposed mortality regulations.

Safe Harbors

Under the Notice, 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 the contract is issued after Dec. 31, 2008, or the contract is issued before January 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued.

For a contract issued under the 2001 CSO, the Notice requires the use of the 2001 CSO for contracts issued on or after Jan. 1, 2009, and permits the use of the 2001 CSO until that time in any state that either allows or requires that the 2001 CSO be used. The effective date provisions follow the adoption dates provided by the NAIC in their regulation adopting the 2001 CSO. The NAIC Model Regulation provides that the 2001 CSO Table can be applied at the option of a company until Jan. 1, 2009, by which time all products offered for sale must be 2001 CSO[9] compliant. In following the NAIC Model, the Internal Revenue Service, in effect, adopted the same transition rules for compliance with the definitional limits as the states have provided for contract nonforfeiture values, thus removing any potential conflict between state law and federal tax law requirements.

At the same time, however, the Notice follows the dual mortality limitation of the proposed mortality regulation rather than the single limitation provided for the 1980 CSO under Notice 88-128. Taken at its face, the safe harbor for "reasonable" mortality must recognize the guaranteed mortality charges specified in the contract, in the event they are less than the applicable 2001 CSO charges.

Under the Notice, the 1980 CSO remains the safe harbor for reasonable mortality under the following conditions:

(1) The mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables.

(2) The mortality charge does not exceed the mortality charge specified in the contract at issuance.

(3) 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 the contract is issued before Jan. 1, 2009.

Like the 2001 CSO requirements, the effective date provisions simply follow the NAIC transition rules, allowing the use of the 1980 CSO until Jan. 1, 2009. However, the safe harbor for the 1980 CSO contains the same dual limitation as the requirements for the 2001 CSO (and the proposed regulation). Since this is different from the safe harbor provided in Notice 88-128, which simply limited the charges to "100 percent of the applicable mortality charges set forth in the 1980 CSO tables," it raises the question of whether an additional requirement has been added to the safe harbor for the 1980 CSO. This applies to both the definitional limitations under Section 7702 and the modified endowment rules under Section 7702A.

If so, issues then arise as to the effective date of the new dual limitation. One interpretation is that the dual limitation applies retroactively to the effective date of the reasonable mortality requirements—replacing the limitation currently found in Notice 88-128. Another is that the limitation does not apply to contracts that were issued before the publication of Notice 2004-61.

[9] *Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation (NAIC, December 2002).*

Questions also arise as to the status of contracts that would meet a limitation computed using the 1980 CSO, but not one recognizing the guaranteed mortality charges in the contract. For their part, the IRS effectively served notice on the industry that the dual limitation was their preferred interpretation as it was included in the 1991 proposed regulations, but they would seem to have difficulty in disqualifying contracts issued in reliance on Notice 88-128.

While notice 2004-61 appears to conform the "reasonable" mortality requirements to widespread industry practice, it also reflects an ongoing IRS concern about potential abuse of the mortality standards.

Smoker-Distinct and Gender-Blended Tables

Notice 2004-61 also provides guidance related to the smoker-distinct and gender-blended tables that are a part of the 2001 CSO "family" of tables, as well as to similar variations of the 1980 CSO. Here again, the safe harbor rules apply to follow the approach from the proposed mortality regulations rather than that of Notice 88-128. While Notice 2004-61 appears to conform the "reasonable" mortality requirements to widespread industry practice, it also reflects an ongoing IRS concern about potential abuse of the mortality standards.

The applicable variations of the tables are available as a safe harbor for reasonable mortality provided that,

(1) A state permits minimum nonforfeiture values to be determined under the smoker-distinct or gender-blended variation of the tables, as applicable; and,

(2) The corresponding tables must be used for nonsmoker or male mortality, as applicable.

The requirement that the tables are to be applied consistently follows the "anti-whipsaw" provisions found in the proposed mortality regulations.

Contract Changes

The effective date language in the Notice uses a contract's issue date to determine whether the 1980 CSO or the 2001 CSO applies to contract changes made after the mandatory Jan. 1, 2009 effective date. In describing the "date on which a contract was issued," the Notice refers to the "standards that applied for purposes of the original effective date of Section 7702."[10] As described in the legislative history, the original transition rules followed the principle that "contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange."

While this language would clearly apply to a new 2001 CSO contract that replaces a 1980 CSO contract, it may also sweep in changes made to existing contracts, depending on the nature and the extent of the change. In this regard, the legislative history (and Notice 2004-61) provides that, "for these purposes, a change in an existing contract is not considered a result in an exchange if the terms of the resulting contract (i.e., 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."

Notice 2004-61 goes on to provide examples of exceptions, noting that if a life insurance contract satisfied the 1980 CSO (or 2001 CSO) safe harbor when originally issued, a change from previous tables to the 2001 CSO tables is not required if:

1) The change, modification or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract;

2) The state in which the contract is issued does not require use of the 2001 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and

3) The contract continues upon the same policy form or blank.

continued ▶▶11

[10] *See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1076 (1984), 1984-3 (Vol. 2) C.B. 330; see also 1 Staff of Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984.*

from pg. 7

The Notice provides examples of transactions that would not require a change to the 2001 CSO, noting that changes, modifications or exercises of contractual provisions 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.

The inclusion of the parenthetical (if the change is not underwritten) caused some concern as to the extent to which changes to existing contracts would require the use of the 2001 CSO to meet the mortality safe harbor after the change. Based on comments from IRS representatives at the SOA fall 2004 seminar on product tax matters, it appears that the IRS is seeking to strike a balance between permitting companies to use the 1980 CSO for most changes, while not giving companies an unrestricted right to increase coverage without limitation while still maintaining qualification under the 1980 CSO. The broad tax law concept of a "material change," which is distinct from the term as applied under section 7702A, appears to govern the potential change as it relates to the applicable reasonable mortality requirements. While no clear line exists for distinguishing one type of underwritten increase from another, it appears that limited increases in coverage would be permissible, while extraordinary increases would require the use of the 2001 CSO on the new segment.

Issues not Addressed

Notice 2004-61, while clarifying many issues related to the transition to the 2001 CSO, is silent on a number of industry concerns. Among the most important of these is the treatment of the maturity date. Under the 2001 CSO Table, the terminal age of the mortality table has been extended to 121, compared to age 100 under the 1980 CSO. Consistent with the terminal age of the 1980 CSO (and 1958 CSO), section 7702(e)(1)(B) deems a life insurance contract's maturity date to be between the insured's ages of 95 and 100. Section 7702 does not require a life insurance contract to endow at age 100, nor does it preclude an insurer from charging for mortality beyond age 100. There may, however, be a question of whether and how the limits continue to apply beyond age 100, the latest "deemed" maturity age under the statute. Similarly, the notice does not provide any guidance related to the use of multiple life or substandard mortality.

Future Developments

The American Council of Life Insurers filed comments with the IRS addressing many of the questions discussed above. It is possible that, in response to the questions that have been raised, additional clarification will be forthcoming. It is also possible, however, that the IRS will consider finalizing the proposed mortality regulations, although the issues of substandard and multiple life mortality are not easily resolvable. For now, Notice 2004-61 provides a new and welcome chapter in the mortality story under sections 7702 and 7702A.

Coming Soon: Survey on the Role of the Tax Actuary

The Taxation Section is putting together a survey to understand actuarial involvement in the company tax function. The survey will be coming out this spring and it will be asking you about the actuary's participation in many aspects of company tax, and your company's tax actuarial career path. Your prompt response to this survey will be greatly appreciated.