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New Proposed Regulations on "Attained Age" Under IRC Section 7702

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On May 24, 2005, the Treasury Department and Internal Revenue Service published a notice of proposed rulemaking (the "Notice") proposing regulations under Internal Revenue Code §7702, the federal tax definition of a "life insurance contract." The proposed regulations explain how to determine the attained age of an insured for purposes of testing whether a contract satisfies the requirements of §7702. In addition to addressing contracts covering a single insured's life, the proposed regulations address the permissible attained age assumptions that may be used under joint life insurance contracts, both first-to-die contracts and last-to-die contracts. As discussed further below, the proposed regulations would apply to contracts issued on or after the date that is one year after the regulations are published as final regulations in the Federal Register.

An insured's attained age is relevant in a number of contexts under §7702, and by cross reference under §7702A, the Code's definition of a "modified endowment contract." In general, the computation of guideline premiums and net single premiums under §7702 and 7-pay premiums under §7702A at any given time requires knowledge of, or an assumption as to, the age(s) of the insured(s) at that time. More particularly, §7702(e)(1)(B) generally provides that the calculations under §7702 must assume that a contract's maturity date is 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. Also, under §7702(e)(1)(C), death benefits are deemed to be provided until this maturity date, and under §7702(e)(1)(D), the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date) is deemed not to exceed the least amount payable as a death benefit at any time under the contract. The insured's attained age also is pertinent to application of the "cash value corridor" requirement of §7702(d), which must be satisfied by contracts intending to comply with the guideline premium limitation.

Rules for attained age. The proposed regulations, which are relatively brief for income tax regulations, begin by establishing a general rule for determining an insured's attained age for purposes of the guideline premium requirements of §7702(c), the cash value corridor of §7702(d), and the computational rules of §7702(e)—which apply to the cash value accumulation test as well, and derivatively, to the §7702A 7-pay premiums. Specifically, the proposed regulations provide that the attained age of the insured under a contract insuring a single life is either: (1) the insured's age determined by reference to the individual's actual birthday as of the date of determination (actual age), or (2) the insured's age determined by reference to contract anniversary (rather than the insured's actual birthday)—sometimes called the "insurance age"—so long as the age assumed under the contract is within 12 months of the actual age. Under these rules, which thus far track statements in the legislative history of §7702 (as noted further below), age-last-birthday and age-nearest-birthday assumptions continue to be permitted. In addition, the proposed regulations require, presumably to preclude any whipsaw effect, that whichever attained age is used for a given contract must be used consistently for purposes of §7702(c), §7702(d) and §7702(e), as applicable.

This same set of requirements also applies for purposes of determining an insured's attained age in the case of contracts covering multiple lives, although with significant exceptions. Specifically, the proposed regulations provide that:

(i) The attained age of the insured under a contract insuring multiple lives on a last-to-die basis—joint and last survivor contracts—is the attained age of the youngest insured.

(ii) The attained age of the insured under a contract insuring multiple lives on a first-to-die basis is the attained age of the oldest insured.

These rules for joint life contracts, as recognized by the government in the preamble to the proposed regulations (which explains the background of and reasons for the

proposal), are without legal precedent and may well run counter to the practices adopted by many insurers. In the case of last-to-die contracts, some insurers have been following rule (i) for a considerable period of time, while others have made use of a joint equal age methodology (discussed below). In the case of first-to-die contracts, it is doubtful that any insurer has followed rule (ii), although application of the rule may not present a problem as a practical matter. If the guideline published by the National Association of Insurance Commissioners (Actuarial Guideline XX) for determining the joint equal age for such contracts is adhered to, it appears that only a very limited group of contracts (depending upon the gender and age relationship of the insureds) would fall on the wrong side of rule (ii). These rules apply regardless of the gender of the insureds or the presence of any smoker or substandard rating applicable to one of them.

Relationship of the proposed regulations to the reasonable mortality charge requirement: The question of joint equal age mortality. Interestingly, the preamble to the proposed regulations disclaims any relationship between the new rules for multiple life contracts and the so-called "reasonable mortality charge" requirement of §7702(c)(3)(B)(i) introduced by TAMRA in 1988. Specifically, the preamble states that the proposed regulations "are not intended to specify which multiple-life actuarial methodologies are appropriate to determine reasonable mortality charges under §7702 and §7702A, or how any such methodology should be applied." Hence, while the proposed rules preclude the use of joint equal age assumptions with respect to deemed maturity dates for purposes of §7702(e), in the passage just quoted the government seemingly indicates a desire not to address in these rules the appropriateness of mortality charges based on joint equal age assumptions under §7702(c)(3)(B)(i).

What is unclear, however, is whether the practical effect of the proposed regulations will be to preclude the use of joint equal age mortality once the regulations become effective. Consider, for example, a second-to-die life insurance contract under which the joint equal age of the insureds at issue is 60, but the age of the younger insured at that time is 53. In this case, the proposed regulations would require use of a deemed maturity date (assuming the younger insured's age 100 is used) in the 47th policy year. In contrast, the use of mortality based on a joint equal age assumption would place the contract's deemed maturity date—when the joint equal age is 100 years—on the 40th policy anniversary, when the younger insured in the example is only 93 years of age. Thus, the use of joint equal age mortality would seem to have the effect of assuming a maturity date prior to the time permitted by the proposed regulations. It also is unclear what adjustments to a joint-equal-age-based mortality assumption might be appropriate to eliminate this apparent problem. If the proposed regulations become effective in their current form, insurers may find it difficult, or even impossible, to apply a joint equal age mortality assumption (at least for certain combinations of insureds) for contracts which the new rules govern.

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Relationship of the proposed regulations to the 2001 CSO tables. Last year, the IRS issued Notice 2004-61, 2004-41 I.R.B. 596 (Oct. 12, 2004), which addressed transition issues relating to the newly prevailing 2001 CSO mortality tables. This IRS notice did not comment on one aspect of the 2001 CSO tables—the relationship between the requirement of §7702 that a deemed maturity date between age 95 and 100 must be used and the fact that the new tables extend to age 121. The proposed regulations on attained age similarly do not speak to this aspect of the new tables. The preamble to the proposed regulations does state that "[t]he deemed maturity date generally is the [termination] date set forth in the contract or the end of the mortality table (which, when §7702 was enacted in 1984, was age 100)." Presumably, the word "generally" was used to reflect the fact that some contracts will need to use a deemed maturity date for §7702 purposes that differs from the termination date set forth in the contract or the end of the mortality table. For example, a contract with guaranteed mortality based on the 2001 CSO tables and a stated termination date of age 121 will nonetheless need to use age 100 as the deemed maturity date because of the computational rule of §7702(e)(1)(B).

Consistency rule. As noted above, the proposed regulations contain a consistency requirement. Specifically, section 1.7702-3(b)(2) of the proposed regulations requires that "whichever attained age is used with respect to a contract must be used consistently from year to year and consistently for purposes of §7702(c), §7702(d), and §7702(e), as applicable." While the promulgation of such a requirement is understandable, its scope is unclear in a number of respects.

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Segment-based methodology. One common practice among insurers is to treat increases in coverage as a new date of issue with respect to the increase and to treat decreases in coverage as eliminating either the most recent coverage increases or a *pro rata* portion of all prior coverages. This practice often is followed when the computer-based administrative system creates an at-issue coverage segment and then a new segment for each increase in coverage. Under this segment-based methodology, when the insurer calculates the attained-age decrement in respect of a coverage decrease, it typically will look to the attained age applicable to each coverage that is being decreased.

To illustrate this practice, assume that a contract was issued on Jan. 1, 2000 with a $100,000 face amount, the insurer applies an age nearest birthday assumption, and on Sept. 1, 1999 the insured turned age 35. Thus, at issue, the insured will be considered age 35 with respect to the $100,000 of coverage. Assume also that on May 1, 2005, coverage is increased by $50,000. Here, using a segment-based approach, the insurer may consider the increase as a new date of issue with respect to the increase, so that the insured will be considered age 41 for purposes of calculating the attained age increment to the guideline premiums, even though the increase occurs during the policy year when the insured is otherwise considered age 40. (Other insurers may focus instead on the policy year during which the increase occurs, and thus treat the insured as age 40 with respect to the increase.) If on May 1, 2006, coverage is decreased by $60,000, the insurer, following the segment-based approach, may treat this as a reduction of the entire $50,000 increase made a year earlier, thus reflecting an attained age of 42 with respect to this portion of the attained-age decrement to be calculated, and as a $10,000 reduction of the initial face amount, thus reflecting an attained age of 41 with respect to this remaining portion of the attained-age decrement to be calculated. On the other hand, an insurer applying a *pro rata* approach would view $100,000/$150,000, or 2/3, of the decrease as attributable to the initial face amount and $50,000/$150,000, or 1/3, of the decrease as attributable to the coverage increase in the prior year. (Insurers focusing on the policy year would assume that the insured is age 41 with respect to the decrease, since the insured is considered that age for the policy year during which the reduction occurred.)

The preamble to the proposed regulations refers to the Senate Finance Committee explanation of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, which states in part that "the attained age of the insured means the insured's age determined by reference to contract anniversaries (rather than the individual's actual birthdays), so long as the age assumed under the contract is within 12 months of the actual age." Significantly for the segment-based approach, the Finance Committee explanation goes on to state that when there is a change in the benefits under a contract, "the date of change for increased benefits should be treated as a new date [of issue] with respect to the changed portion of the contract." This passage may be read as providing explicit support for the segment-based approach that many insurers have applied.

Ultimately, each of the practices described above should be viewed by the IRS as in conformity with the consistency rule in the proposed regulations, although it would be useful if this were clarified. In many cases, the approach adopted is deeply embedded in the computer-based administration system that monitors contracts' compliance with §7702 and §7702A, and thus any contrary view could present significant difficulties for insurers.

§7702(c) vs. §7702(d). Another question that has been raised is whether the consistency rule requires use of the same assumption for purposes of calculating guideline premiums and applying the cash value corridor. Seemingly, this should not be necessary as long as the age assumption used with respect to each of these respective requirements is consistently applied.

Contractual assumptions. A further question is whether age assumptions contained within a contract (used, for example, for purposes of determining guaranteed mortality charges) must be used under §7702, e.g., if a contract sets forth mortality guarantees based on an age-last-birthday assumption, is it permissible to calculate guideline premiums using an age-nearest-birthday assumption? Generally speaking, where §7702 does not prescribe a particular treatment for an aspect of the calculations, it is appropriate to follow the mechanics of a contract, since such a practice usually will be actuarially reasonable in the circumstance. The statute does not, however, expressly require this, and thus the extent to which variations in practice are permitted is unclear in some respects. We observe that the second example of section 1.7702-3(e) of the proposed regulations describes use of an age-nearest-birthday assumption and notes that "under the contract" premiums were determined on this basis. In addition, one of the safe harbors with respect to the reasonable mortality charge rule set forth in Notice 2004-61 limits the charges that can be reflected under

§7702 to those guaranteed under the contract, and thus insurers intending to utilize this safe harbor generally will need to reflect contractual age assumptions in their guideline premium calculations.

The scope of the consistency requirement is unclear at present, and there may well be other common practices that could raise questions.

Effective date. The proposed regulations, as previously noted, generally would apply to contracts issued on or after the date that is one year after the regulations are published as final regulations in the Federal Register. The proposed regulations provide, however, that a taxpayer may elect to apply the proposed regulations retroactively for contracts issued earlier, so long as the taxpayer does not later determine qualification of those contracts in a manner that is inconsistent with the proposed regulations.

Given the general prospective application of the regulations' guidance, questions have been asked about the appropriateness of practices, such as joint equal age assumptions and age rate-ups, that insurers have used and continue to use with respect to contracts not subject to the requirements of the Notice, i.e., contracts issued before the above described effective date. Technically, the regulations do not in any way address such contracts or the appropriateness of any particular practices applied to determine their compliance (apart from the effective date rule permitting a taxpayer to apply the guidance retroactively to such contracts). Thus, the appropriateness of any particular interpretation of §7702 and associated practice must be determined based on the requirements as set forth in the statute and other authorities such as legislative histories pertinent to such requirements. They must be judged, in other words, based on the law as it exists without regard to the proposed regulations.

While the proposed regulations thus do not provide any comfort with respect to prior and existing practices (unlike, for example, the relief provided in Rev. Rul. 2005-6 with respect to the treatment of qualified additional benefits), it can fairly be said that the government has been aware of the use of various practices, such as joint equal age assumptions. The preamble to the proposed regulations states that the regulations are "consistent with the existing practice of many (but not all) issuers of both contracts insuring a single life and contracts insuring multiple lives." Thus, the choice of a prospective effective date for the proposed new rules provides some indication that the government is not interested in challenging such practices, as long as they were actuarially reasonable.

Request for comments and the scheduled hearing. The Notice states that written or electronic comments must be provided by Aug. 24, 2005. Also, the Notice states that a public hearing is scheduled to take place on Sept. 14, 2005, and that requests to speak and outlines of topics to be discussed at that hearing must be received by Aug. 24, 2005. With respect to written comments, the Notice specifically requests comments on four topics:

1) The clarity of the proposed regulations and how they can be made easier to understand;

2) The industry's existing practice for determining the attained age to use under both last-to-die and first-to-die life insurance contracts;

3) The need for special rules for determining the attained age of one or more insureds to calculate mortality charges under the reasonable mortality charge rule of section 7702(c)(3)(B)(i); and

4) The effective date of the proposed regulations.

Insurers should think about their practices in regard to these (and other) points and consider providing input. The third point in particular may reflect the government's intention to address application of the reasonable mortality charge rule to joint life products in subsequent guidance.

Concluding thoughts. At the time of the enactment of §7702 in 1984, joint life products existed in the market, but there was no mention of such products in the statute or legislative history, and it has been unclear in certain respects how the statute would be applied to such contracts. With the amendment of §7702A in 1989, there finally came to be a statutory reference to the joint and last survivor product, but still little guidance existed.

The IRS and U.S. Treasury Department are to be commended for their efforts in promulgating guidance on these issues. In our view, much remains to be done in refining the proposed rules, particularly as they affect joint life products. We understand the government to be determined to finalize the proposed regulations, and equally determined to listen carefully to what commentators say about the proposal. Insurance industry input to the regulatory process is vital if workable rules are to be fashioned, together with needed transitional relief. ◀

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