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2001 CSO Implementation Under IRC Sections 7702 and 7702A

2001 CSO Maturity Age Task Force

Section 7702 of the Internal Revenue Code (the Code) places limits on the investment orientation of life insurance contracts, either by restricting the allowable premium paid into the contract or by mandating minimum death benefits, or both. It also places restrictions on the assumptions underlying the calculation of these limits. With respect to mortality, the tax law allows the use of "reasonable mortality" in computing these limitations, and specifies the prevailing CSO table as an upper limit on reasonable mortality.

For tax testing of policies issued on or after January 1, 2009, the 2001 CSO Mortality Table is required. There are several characteristics of the 2001 CSO table that distinguish it from prior CSO tables, most notably the extension of the table beyond age 100. Because the 2001 CSO table extends to age 121, it's likely that companies will be developing contracts with maturity dates beyond age 100. This will raise some fundamental questions regarding how such contracts should be administered under Section 7702 and 7702A. Many of these questions are linked to the computational rules of Section 7702(e)(1), which limit the future benefits that can be incorporated into the calculation of guideline and net single premiums. Of particular note is Section 7702(e)(1)(B) which provides that the maturity date assumed in the calculations 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 the Treasury Department and the Internal Revenue Service on the proper application of the current computational rules to the 2001 CSO Mortality Table but, to date, such guidance has not been provided. Therefore, the Taxation Section established the 2001 CSO Maturity Age Task Force to propose methodologies that would be actuarially acceptable under Sections 7702 and 7702A of the Code for calculations under contracts that do not provide for actual maturity before age 100. The task force recommendations 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) of the Code, and the necessary premium calculations, of Section 7702A(c)(3)(B)(i) of the Code, will be for an endowment at age 100.
- The guideline level premium present value of future premium calculations, of Section 7702(c)(4) of the Code, will assume premium payments through attained age 99.
- The sum of guideline level premiums, of Section 7702(c)(2)(B) of the Code, 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 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 because 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) of the Code, 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.

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