SOCIETY OF ACTUARIES

Article from:

Taxing Times

February 2011 – Volume 7 Issue 1

LIFE BEYOND 100: REV. PROC. 2010-28 FINALIZES THE "AGE 100 METHODOLOGIES" SAFE HARBOR

By John T. Adney, Craig R. Springfield, Brian G. King and Alison R. Peak

In 2009 the Internal Revenue Service ("Service") issued Notice 2009-47,[1] which proposed a safe harbor for calculations under sections 7702 and 7702A[2] in the case of life insurance contracts that mature after the insured attains age 100. After receiving comments from the life insurance industry, including the American Council of Life Insurers ("ACLI"), the Service released Revenue Procedure 2010-28,[3] which sets forth the final safe harbor, in August 2010. The new guidance largely adheres to the recommendations made by the 2001 CSO Maturity Age Task Force formed by the Taxation Section of the Society of Actuaries in 2005 ("SOA Task Force"). The Task Force's recommendations were published in *Taxing Times* in May 2006.

To satisfy the cash value corridor, the death benefit under the contract at any time cannot be less than the applicable percentage of the cash surrender value as determined under the table set forth in section 7702(d)(2).

Rev. Proc. 2010-28 has been welcomed by many in the industry as a helpful clarification of the application of sections 7702 and 7702A to life insurance contracts that are based on the 2001 CSO mortality tables ("2001 CSO Tables"). Under the safe harbor, the Service will not challenge the qualification of a contract as a life insurance contract under section 7702, or assert that a contract is a modified endowment contract ("MEC") under section 7702A, if the contract satisfies the requirements of those provisions using the "Age 100 Safe Harbor Testing Methodologies" prescribed in section 3.02 of Rev. Proc. 2010-28.

In this article, which follows our September 2009 *Taxing Times* article,[4] we first briefly review the relevant Code provisions and the background to the issuance of Rev. Proc. 2010-28. We then delve into the revenue procedure's Age 100 Safe Harbor Methodologies and some considerations that insurers should keep in mind in applying these Methodologies. Finally, we conclude with a discussion of several points not addressed in the revenue procedure. For additional background on this subject, we refer you to our September 2009 *Taxing Times* article, "IRS Issues Proposed Safe Harbor Prescribing 'Age 100 Methodologies.'"

RELEVANT PROVISIONS OF THE CODE

Section 7702. Section 7702 contains the definition of a "life insurance contract" for all purposes of the Code, generally applying to life insurance contracts issued after Dec. 31, 1984.[5] To qualify as a life insurance contract, a contract must be a life insurance contract under applicable law and must satisfy either the cash value accumulation test (the "CVA Test") of section 7702(a)(1) and (b) or the guideline premium limitation and cash value corridor test (the "GP Test") of section 7702(a)(2), (c) and (d).

As provided in section 7702(b)(1), a contract will satisfy the CVA Test if, by the terms of the contract, its cash surrender value, as defined by section 7702(f)(2), may not at any time exceed the net single premium required at such time to fund the future benefits under the contract. Determinations under the CVA Test are based upon the computational rules of section 7702(e). Under the alternative testing method, a contract will satisfy the GP Test if the contract satisfies both the requirements in section 7702(c), regarding the guideline premium limitation, and the requirements in section 7702(d), imposing the cash value corridor test. To meet the guideline premium limitation, the sum of the premiums paid under the contract cannot at any time exceed the guideline premium limitation,[6] which as of any date is the greater of the guideline single premium or the sum of the guideline level premiums to that date.[7] Subject to a number of computational rules and constraints, the guideline single premium is the premium at issue that would be required to fund the future benefits under the contract.[8] Similarly, the guideline level premium is the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that the interest rate assumption used is 4 percent instead of 6 percent.[9] To satisfy the cash value corridor, the death benefit under the contract at any time cannot be less than the applicable percentage of the cash surrender value as determined under the table set forth in section 7702(d)(2).

Governing the application of both the CVA Test and the GP Test are certain computational rules found in section 7702(e). Of central importance to the new guidance, the computational rule in section 7702(e)(1)(B) provides that for purposes of both tests, "the maturity date [of a contract] … shall be deemed to 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." Prior to the issuance of Rev. Proc. 2010-28, only limited guidance had addressed the statute's deemed maturity date of a life insurance contract: a private letter ruling on the subject was issued by the Service during 2008,[10] and more broadly, Treas. Reg. § 1.7702-2 provided guidance on the attained age of the insured for purposes of applying the endowment or maturity date rules of section 7702(e).

Modified Endowment Contracts. Section 7702A provides that a life insurance contract is a modified endowment contract ("MEC") if the contract is entered into on or after June 21, 1988, and either fails to meet the 7-pay test or is received in exchange for a MEC. A contract that satisfies the 7-pay test will maintain the traditional treatment of withdrawals and loans that has applied to life insurance contracts. Under a MEC, however, distributions (including loans) are treated as distributions of income before any investment in the contract is recovered, and a penalty tax also may apply. A life insurance contract fails to meet the 7-pay test (and thus constitutes a MEC) if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums that would have to be paid on or before such time if the contract were to provide for paid-up future benefits (including death benefits) after the payment of 7 level annual premiums. Under section 7702A(c)(1)(B), the determination of the 7 level annual premiums generally is made by applying the computational rules of section 7702(e), including the rule deeming the maturity date to 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.

Mortality Tables. Guideline premiums and net single premiums are determined on the basis of reasonable mortality charges that 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.[11] The same reasonable mortality charge standard applies for purposes of applying the 7-pay test under section 7702A(c)(1)(B). Section 807(d)(5)(A), in turn, provides that the term "prevailing commissioners' standard tables" means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners that 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, subject to a 3-year transition period allowed by section 807(d)(5)(B). The 2001 CSO Tables became the prevailing tables within the meaning of section 807(d)(5) during 2004 and are mandatory in all 50 states and the District of Columbia for contracts issued after Dec. 31, 2008.

HISTORY BEHIND THE GUIDANCE

The 2001 CSO Tables extend to age 121, whereas the prior CSO tables—the 1958 and 1980 CSO Tables—ended at age 100. Due to this change, life insurance companies now typically issue life insurance contracts with maturity dates at age 121 (and, as was the case even under prior mortality tables, some contracts do not specify any maturity date). With these changes in contract design, questions began to arise with respect to how such contracts should be administered under sections 7702 and 7702A. Specifically, in calculating guideline premiums and net single premiums, some wondered whether it was permissible to use a contract's actual maturity date, even though such date exceeded the maximum deemed maturity date (age 100) specified in section 7702. Others were concerned with how the tests should be applied technically, even if it was assumed that the maximum age of 100 controlled. Still others were concerned about the seemingly inconsistent requirements of the statute's maximum deemed maturity date and the requirement of calculating a "7-pay" premium under section 7702A in circumstances where a contract was issued or materially changed within less than 7 years of the maximum deemed maturity date.

In 2005, the SOA Task Force was formed to study the interaction of the 2001 CSO Tables and the tax law, including the application of section 7702's requirement of a deemed maturity date between the insured's age 95 and 100 to a contract that may provide coverage through the end of the 2001 CSO Table at the insured's age 121. The SOA Task Force proposed methodologies, published in the May 2006 issue of *Taxing Times*, that would be actuarially acceptable under sections 7702 and 7702A for calculations under contracts that do not provide for actual maturity by or before age 100. The ACLI and others in the life insurance industry also had conversations with the Service and Treasury Department requesting that guidance be issued on this subject.[12]

CONTINUED ON **PAGE 12**

The Service and Treasury Department responded by issuing Notice 2009-47 (the "Notice"), which set forth a proposed safe harbor and requested comments on certain issues that could arise in situations where a life insurance contract matures after the insured has attained age 100. While the proposed safe harbor generally followed the recommendations of the SOA Task Force, it included a condition limiting its application to cases where the contract provided at all times a death benefit equal to or greater than 105 percent of the contract's cash value. Few if any existing contracts or approved forms met such a condition, of course, and the ACLI and others submitted comments in response to the Notice[13] objecting to the 105 percent corridor, suggesting technical changes to the Notice's other safe harbor rules, and responding to questions on constructive receipt and like issues raised in the Notice.[14]

Following up on the Notice, the Service released Rev. Proc. 2010-28 in August 2010, in most key respects adopting the methodologies that were set forth in the Notice. In doing so, the revenue procedure specifically references the role of the SOA Task Force and the publication of its recommendations in *Taxing Times*. Rev. Proc. 2010-28 also rectifies certain minor problems that were present in the Notice's safe harbor rules and, significantly, eliminates the onerous 105 percent corridor condition. Apart from eliminating that condition, the revenue procedure maintains silence on the considerations that appear to have led the Service to incorporate the condition in the Notice, including on the questions the Service raised in the Notice. Instead, Rev. Proc. 2010-28 applies—and provides a safe harbor—only with respect to the application of sections 7702 and 7702A. Limiting the guidance only to the application of sections 7702 and 7702A is consistent with comments the Service received, *i.e.*, to the effect that the safe harbor should address only the application of these Code provisions and should not try to address the extraneous issues such as the application of the constructive receipt doctrine after an insured's age 100.

AGE 100 SAFE HARBOR METHODOLOGIES

The safe harbor in Rev. Proc. 2010-28 provides that the Service will not challenge the qualification of a contract as a life insurance contract under section 7702, or assert that a contract is a MEC under section 7702A, if the contract satisfies the requirements of those provisions using all of the "Age 100 Safe Harbor Testing Methodologies." (See sidebar, page 15). According to the "Purpose" statement at the outset of the revenue procedure, the safe harbor concerns the application of sections 7702 and 7702A to life insurance contracts that 1) have mortality guarantees based on the 2001 CSO Tables, and 2) may continue in force after the day on which the insured attains age 100.[15] It is clear that the guidance applies to contracts that are subject to 2001 CSO Tables; it is less clear whether contracts subject to 1980 CSO Tables can also fall within this safe harbor. While Rev. Proc. 2010-28 appears to apply technically only to a contract based on the 2001 CSO mortality tables (since the "Purpose" section of the revenue procedure states that it provides a safe harbor for contracts with mortality guarantees based on the 2001 CSO Tables), it would be a sound practice to use the Age 100 Safe Harbor Methodologies for a contract subject to the 1980 CSO Tables. Thus, for example, even though the 1980 CSO Tables terminate at an insured's age 100, those Methodologies could be employed in the case of universal life insurance contracts with maturity dates beyond age 100 or whole life insurance contracts that do not specify any maturity date.

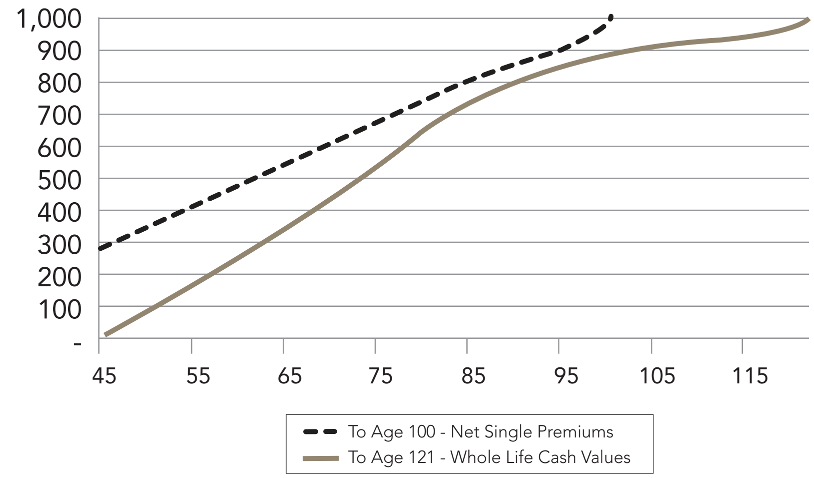
Calculations. Rev. Proc. 2010-28 makes it clear that in order to take advantage of the safe harbor, for all calculations under sections 7702 and 7702A (other than the cash value corridor), the contract must be deemed to mature on age 100, notwithstanding a later contractual maturity date.[16] The rest of the safe harbor methodologies are keyed to this assumption. In that regard, the date the insured attains age 100 must be used as the endowment date for calculating net single premiums and necessary premiums.[17] Furthermore, to determine the guideline level premium, premium payments must be assumed to be made through the day the insured attains age 99.[18] Also, for purposes of the 7-pay test, in the case of a contract issued or materially changed within fewer than 7 years of the day the insured attains age 100 (which likely would be very unusual for most contracts), the net level premium must be computed assuming level annual premium payments over the number of years between the date the contract is issued or materially changed and the date the insured attains age 100.[19]

To illustrate the effect of these rules, consider the example of an ordinary whole life insurance contract with cash values based on the 2001 CSO Tables and 4 percent interest. The first graph to the right compares the development of the guaranteed tabular cash values of such a contract (which reflect the termination of the 2001 CSO Tables at age 121) with the net single premiums under section 7702(b) (which reflect the deemed maximum maturity date of age 100).

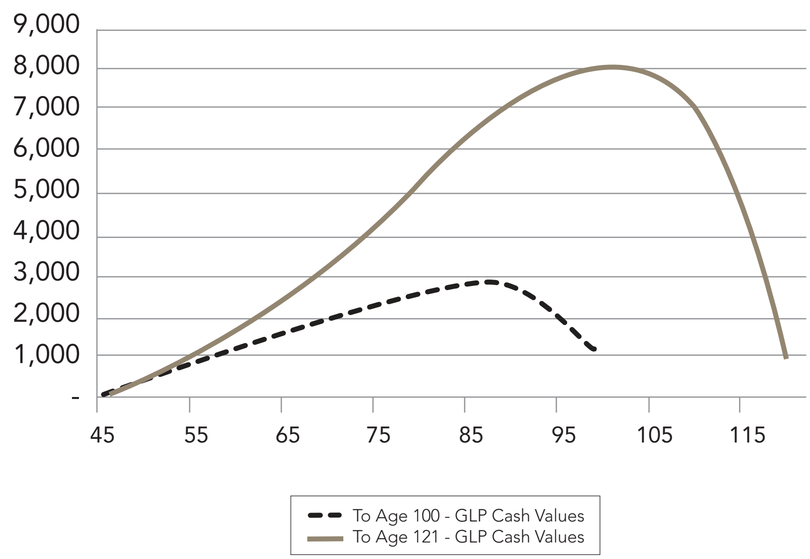
As another illustration, consider the example of a universal life insurance contract with mortality guarantees based on the 2001 CSO Tables and 4 percent interest that is funded with level annual premiums and provides an increasing death benefit (equal to face plus cash value). The second graph to the right first shows the development of cash values based on level annual premiums (determined without regard to the guideline premium limitation) that are sufficient in amount to allow adequate funding to age 121, so that an endowment benefit equal to the face amount may be paid on that date. The graph then, however, shows the development of guaranteed cash values based on payment of guideline level premiums, which are lower than those that allow for full funding due to the requirement to reflect a maximum deemed maturity date of age 100. Thus, in this second illustration, the requirement to use a maturity date not exceeding age 100 in the calculation of the guideline level premium reduces the otherwise applicable limitation.

Time Periods. In addition to the calculations for section 7702 and 7702A, the safe harbor also provides guidance with respect to the various testing periods. More specifically, the safe harbor provides that guideline level premiums accumulate through a date no earlier than the day the insured attains age 95 and no later than the day the insured attains age 99.[20] Thereafter, premium payments are allowed and are tested against the guideline premium limitation, but the sum of the guideline level premiums does not change after the day the insured attains age 100.[21] Also, in the case of a contract issued or materially changed within fewer than 7 years of the day the insured attains age 100, the sum of the net level premiums increases until the day the insured attains age 100.[22] Thereafter, the sum of the net level premiums does not increase, but premium payments are allowed and are tested against this limit for the remainder of the 7-year period.[23]

CASH VALUE PER $1,000 OF DEATH BENEFIT
Male, Issue Age 45



CASH VALUE PER $1,000 OF DEATH BENEFIT
Male, Issue Age 45



CONTINUED ON **PAGE 14**

At first glance it appears that there is a discrepancy between the date assumption required for the accrual of guideline level premiums (*i.e.*, through age 99) and the date after which the guideline premium limitation does not change (*i.e.*, after age 100). Although not expressly stated, the difference appears to account for the possibility of an adjustment event in the 99th year. More specifically, it appears that section 3.02(d) of Rev. Proc. 2010-28 contemplates that the last guideline level premium would accrue on the date the insured attains age 99, and the sum of guideline level premiums would not thereafter be altered except in the case of an adjustment event during the contract year when the insured has an attained age of 99. Little guidance exists regarding how mid-year adjustment events should be handled in the context of the guideline level premium, and practices among insurers may vary while still being actuarially sound as well as consistent with the statutory requirements. It is perhaps appropriate that the Service did not address what specifically needs to be done to the sum of guideline level premiums upon a change during the 99th year, while at the same time recognizing that some change may be needed due to an adjustment event prior to the date when the insured reaches attained age 100.

Little guidance exists regarding how mid-year adjustment events should be handled. …

A similar issue exists for the calculation of 7-pay premiums under section 3.02(e) and (f) of Rev. Proc. 2010-28. These provisions similarly appear to contemplate that net level premiums generally would accrue until the insured's attained age of 99, but thereafter 7-pay premiums may need to be recalculated if there is a material change in the 99th year. While section 3.02(f) of Rev. Proc. 2010-28 could be read as contemplating accrual of the final net level premium on the date the insured reaches attained age 100, assuming a final payment at age 99 appears to be intended. This is because "net level premiums" are assumed paid at the beginning of each year of the applicable period, the end of the applicable period is the insured's age 100, per section 3.02(a) of Rev. Proc. 2010-28, and section 3.02(e) of Rev. Proc. 2010-28 specifies that net level premiums are calculated "over the number of years between the date on which the contract is issued or materially changed and the date on which the insured attains age 100."

To illustrate these rules, consider the case of a life insurance contract covering a male insured with a $100,000 level death benefit, guaranteed cash values based on the 2001 CSO Tables and 4 percent interest, and a current cash value of $ 47,200 on the date of a material change under section 7702A(c)(3)(A)(i), when the insured is age 96. In this circumstance, a 4-pay premium effectively is calculated (tentatively equal to $35,362) before application of the so-called "rollover rule" of section 7702A(c)(3)(A)(ii). Also, under the rollover rule, this tentative 4-pay premium is reduced by the product of (1) the cash surrender value as of the date of the material change ($47,200) (which we have assumed is not in part due to payment of unnecessary premiums), and (2) a fraction the numerator of which equals the 4-pay premium for the future benefits under the contract and the denominator of which equals the net single premium for such benefits computed using the same assumptions used in determining the 4-pay premium (.38717), with the resulting 4-pay premium being $17,087.

Changes to Contracts. If a contract is issued or materially changed within fewer than 7 years from the time the insured attains age 100 (so that, for example, a 4-pay premium is calculated, as discussed above), and the contract thereafter has a reduction in benefits, the reduction in benefits rule under section 7702A(c)(2) will apply for 7 years from the date of issue or the date of the material change (*i.e.*, in the example, it would apply for 3 years beyond the period during which 7-pay premiums accrue).[24] Also, in the case of a joint and survivor life insurance contract, the reduction in benefits rule would apply for the life of the contract pursuant to section 7702A(c)(6), including after one or both of the insureds attains age 100.[25] By so applying these reduction in benefits rules under the safe harbor, the Service appears to have intended to preserve the anti-abuse nature of the rules. Also, application of these rules beyond age 100 can relate back to calculations prior to age 100, which arguably is not inconsistent with the maximum deemed maturity date requirement.

In contrast, a change in benefits under (or in other terms of) a life insurance contract that occurs on or after the insured attains age 100 is not treated as a material change for purposes of section 7702A(c)(3) or as an adjustment event for purposes of section 7702(f)(7).[26] Thus, necessary premium testing under section 7702A(c)(3)(B)(i) ceases on the day the insured attains age 100.[27] Because the adjustment rule no longer applies after this date, the recapture rules of section 7702(f)(7)(B) – (E) also cannot apply, since one of the prerequisites to application of these rules is that there must be "a change described in [section 7702(f)(7)(A), *i.e.*, the adjustment rule, that] reduces benefits under the contract."

NO INFERENCE AND OTHER ISSUES

A much appreciated, and appropriate, clarification is the inclusion of "no inference" language in section 3.03 of Rev. Proc. 2010-28. Specifically, in keeping with a request made in the ACLI's letter commenting on Notice 2009-47, the section states that "[n]o adverse inference should be drawn with respect to the qualification of a contract as a life insurance contract under § 7702, or its status as not a MEC under § 7702A, merely by reason of a failure to satisfy all of the requirements of this section [of Rev. Proc. 2010-28]." This "no inference" provision reinforces the fact that the Age 100 Safe Harbor Methodologies are just that, a safe harbor, and not black letter law for purposes of applying sections 7702 and 7702A to contracts that have maturity dates after the insured's age 100.

A further "no inference" provision states that "[f]urthermore, this revenue procedure neither answers nor comments on any issue raised in Notice 2009-47 that is not specifically covered by the safe harbor in this revenue procedure."[28] As mentioned above, the revenue procedure did not include the requirement that the contract provide a death benefit at all times equal to 105 percent of the cash value. Thus, Rev. Proc. 2010-28 does not address the issues that gave rise to this requirement, *e.g.*, regarding application of the constructive receipt doctrine. Based on this further "no inference" provision, it appears that the Service revised the scope of the guidance so as to focus only on the technical requirements of sections 7702 and 7702A, which is consistent with the scope of the SOA Task Force recommendations. In limiting the scope of the guidance and by including this further "no inference" provision, the Service has clarified that Rev. Proc. 2010-28 should not be construed, one way or the other, as adopting a position with respect to those issues associated with the 105 percent corridor.

CONCLUDING THOUGHTS

Sections 7702 and 7702A are highly technical, involving a combination of legal and actuarial requirements, and developments such as the promulgation of the 2001 CSO Tables certainly have the potential to exacerbate uncertainty. The Service is to be commended for its efforts with respect to Rev. Proc. 2010-28, in the process used to develop the guidance (working with the industry and taking into consideration the SOA Task Force's recommendations), in offering the final guidance in the form of a safe harbor, and in emphasizing the "safe harbor" nature of the guidance, since the requirements of the statutes may be interpreted in other reasonable and actuarially appropriate manners.

A Shorthand Guide to the New Age 100 Safe Harbor Methodologies

(a) All section 7702 and 7702A calculations assume age 100 maturity.

(b) NSP (CVAT) and "necessary premium" calculations assume endowment at age 100.

(c) GLP is calculated assuming premiums through age 99.

(d) GLPs accrue through date between ages 95 and 99, after which limit applies indefinitely.

(e) 7-pay premiums are computed using remaining durations to age 100.

(f) If 7-pay premiums accrue over fewer than 7 years under (e), accrual ends at age 100, after which limit applies for the remainder of the 7-pay period.

(g) Reduction-in-benefit rules apply regardless of attaining age 100.

(h) Benefit change after age 100 is not material change or adjustment event.

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jtadney@davis-harman.com.*

Craig R. Springfield is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *crspringfield@davis-harman.com.*

Brian G. King, FSA, MAAA, is a managing director, Insurance Actuarial Services with LECG and may be reached at *bking@lecg.com.*

Alison R. Peak is an associate with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *arpeak@davis-harman.com.*

CONTINUED ON **PAGE 16**

END NOTES

1 2009-24 I.R.B. 1083.
2 Unless otherwise indicated, all references to "section" are to provisions of the Internal Revenue Code of 1986, as amended (the "Code").
3 2010-34 I.R.B. 270.
4 John T. Adney, Craig R. Springfield, Brian G. King and Alison R. Peak, "IRS Issues Proposed Safe Harbor Prescribing 'Age 100 Methodologies,'" *Taxing Times*, vol. 5, no. 3, at p. 19 (Sept. 2009).
5 Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984).
6 Section 7702(c)(1).
7 Section 7702(c)(2).
8 Section 7702(c)(3).
9 Section 7702(c)(4).
10 PLR 200910001 (Sept. 8, 2008) (holding that the net single premium for individual certificates provided under a group permanent variable life insurance contract will be determined by assuming that the face amount of each contract is provided until age 100 of the insured). Private letter rulings cannot be cited as precedent, and only the taxpayer that receives the ruling may rely on it. *See* section 6110(k)(3).
11 *See* sections 7702(b)(2)(B), 7702(c)(3)(B)(i) and 7702(c)(4).
12 Letter from Laurie Lewis, Senior Vice President, Taxes & Ret. Sec., ACLI, to the IRS (Jan. 10, 2005) (submitting comments on Notice 2004-61, 2004-2 C.B. 96 and requesting guidance on the application of section 7702(e)(1)(B)).
13 Letter from Walter Welsh, Executive Vice President, Taxes & Ret. Sec., ACLI, to the IRS (Oct. 6, 2009) (submitting comments under Notice 2009-47).
14 These responses are discussed in our article cited in note 4, *supra*.
15 Rev. Proc. 2010-28, § 1.
16 *Id.*, at § 3.02(a).
17 *Id.*, at § 3.02(b).
18 *Id.*, at § 3.02(c).
19 *Id.*, at § 3.02(e).
20 *Id.*, at § 3.02(d).
21 *Id.*
22 *Id.*, at § 3.02(f).
23 *Id.*
24 *Id.*, at § 3.02(g).
25 *Id.*
26 *Id.*, at § 3.02(h).
27 *Id.*
28 *Id.*, at § 3.03.