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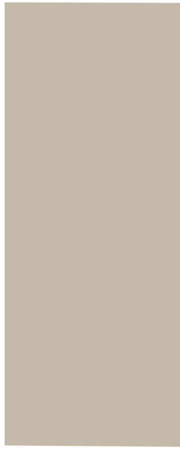

THE PERILS OF REDUCING DEATH BENEFITS: PRIVATE LETTER RULING 201230009

By John T. Adney and Craig R. Springfield

In PLR 201230009 (Jan. 30, 2012), the Internal Revenue Service (the "Service") ruled that a reduction in death benefit accomplished by a contractual modification would cause a life insurance contract to be treated as "newly issued" for purposes of § 5 of Notice 2006-95[1] (the "Notice"), which relates to certain safe harbors for satisfying the reasonable mortality charge requirements of section 7702(c)(3)(B)(i).[2] Consequently, if this private letter ruling is correct, it would no longer be permissible to use the 1980 Commissioners' Standard Ordinary ("CSO") mortality tables for purposes of the calculations under section 7702 following such a death benefit reduction.

FACTS

The life insurance contracts involved in PLR 201230009 complied with section 7702, the federal tax definition of "life insurance contract," by satisfying the cash value accumulation test of section 7702(b), and the computations required by section 7702 were performed using the 1980 CSO mortality tables. The ruling states that owners of the contracts in some circumstances want to decrease their death benefits and that the decreases contemplated are not ones resulting from application of a formula or other provision set forth in the contracts. Rather, the decreases would be accomplished by modifications to the existing contracts, since the contracts do not provide owners with a contractual right to decrease their death benefits.[3] The ruling also lists various non-tax-related reasons why an owner might want to decrease the contract's death benefit, *e.g.*, if the owner no longer needs the full amount of the original coverage, market downturns under a variable contract which increase the net amount at risk and cost of the contract, or the owner's inability to afford the original premiums.

TAXPAYER'S USE OF NOTICE 2006-95 SAFE HARBORS

The issuer of the contracts (*i.e.*, the taxpayer in the ruling) represented that the contracts qualified under the safe harbors in Notice 88-128[4] and Notice 2006-95 that deem mortality charges based on the 1980 CSO mortality tables to be "reasonable" mortality charges for purposes of the reasonable mortality charge requirement of section 7702(c)(3)(B)(i). This statutory provision requires use of "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."[5] Notice 2006-95 provides safe harbors for satisfying section 7702(c)(3)(B)(i) in the case of 1980 CSO contracts, but limits the scope of those safe harbors to contracts "issued"[6] before Jan. 1, 2009.

MATERIAL CHANGE RULES APPLICABLE TO SAFE HARBORS

Notice 2006-95 includes special rules for determining whether a change will cause a contract to be treated as newly "issued" for purposes of applying the Notice. In particular, § 5.01 of the Notice establishes a general material change rule, stating that "the date on which a contract was issued generally is to be determined according to the standards that applied for purposes of the original effective date of § 7702." This § 5.01 standard more or less tracks statements in the legislative history of the effective date of section 7702, which generally treats changes in the material terms and benefits of a contract as resulting in a deemed exchange (and thus new "issuance" of a contract) if the change is not pursuant to a contractual right.[7] Also, § 5.02 of Notice 2006-95 provides an alternative rule for avoiding new "issue" treatment, stating that:

> "[I]f a life insurance contract satisfies [one of the Notice's safe harbors for use of 1980 CSO] 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 ON **PAGE 14**

In PLR 201230009, the taxpayer represented that it would grant an owner's request for a decrease in death benefit only if the second and third of the above Notice § 5.02 requirements were met. Thus, the subject of the ruling was whether the first of the above requirements was met. In particular, the question posed was whether new "issue" treatment of the contract could be avoided for purposes of applying the Notice even though the proposed decreases in death benefits would be accomplished through contractual modifications, requiring the insurance company's consent, rather than pursuant to any contractual rights possessed by owners of the contracts.

THE SERVICE'S ANALYSIS

In its analysis of the issue, the Service focused on the fact that the proposed change would not occur as a result of the exercise of a contractual right, and because of this characteristic of the transaction, the Service concluded that the change was not "pursuant to the terms of the contract" within the meaning of § 5.02 of Notice 2006-95. The Service recognized that some life insurance contracts include contractual rights to reduce the amount of coverage, but commented that the proposed death benefit decreases under the contracts "neither occur[] automatically upon the satisfaction of a condition set forth in the Contracts nor as a result of the exercise of any contractual right provided to a party to the contract." Based on these considerations, the Service ruled that: "A reduction in the face amount under a Contract, pursuant to the owner's request and with [the insurance company's] consent, results in an exchange that causes the Contract to be treated as newly issued for purposes of reasonable mortality charge requirements of § 7702(c)(3)(B)(i)."[8]

COMMENTARY

The Service's position in PLR 201230009 has generated significant concern within the life insurance industry, in part because it may force insurers to prohibit decreases in death benefits where policyholders do not possess a contractual right to make the change (even if the insurer has commonly permitted such transactions in the past) and also due to difficulties that would arise if the rationale that seems to underlie the Service's position were applied more broadly.[9] The rationale of the ruling also portends possible difficulties for the future: for example, insurers today may commonly permit certain extra-contractual changes to 2001 CSO contracts since "new issue" treatment would not affect the applicable mortality table under the reasonable mortality charge rule; however, those insurers might have to stop those practices when and if a new mortality table becomes prevailing.[10] And of course they likely then will need to explain to policyholders why the tax law imposes this restriction, even though no intervening change in the tax law has occurred and the new mortality table does not apply to the contract under state law. This is perhaps an apt point to remind the reader that a private letter ruling is directed only to the taxpayer who requested it, and a ruling cannot be used or cited (by the government or any other taxpayer) as precedent.[11] Of course, the issue addressed will often affect whether a contract complies with section 7702, and thus the Service's current position as reflected in the ruling cannot be ignored. The question nevertheless remains whether the ruling is correct, and what arguments and considerations are pertinent to this question.

POLICY CONSIDERATIONS RELATING TO USE OF THE DEFRA LEGISLATIVE HISTORY'S MATERIAL CHANGE STANDARD

An examination of the origin of the material change rules of § 5 of Notice 2006-95 is helpful in considering this question. In particular, the Service's initial guidance on how contract changes affect application of the reasonable mortality charge rule was contained in Notice 88-128, which was issued in the immediate aftermath of Congress' enactment of the reasonable mortality charge rule as part of TAMRA. Notice 88-128's material change rule is mirrored in § 5.01 of Notice 2006-95, in that they both define material changes by cross-referencing the material change standard contained in the DEFRA legislative history for the effective date of section 7702. We think it is pertinent to keep in mind that, at the time of Notice 88-128's issuance, Congress had just enacted the reasonable mortality charge rule to prevent taxpayers from over-stating guaranteed mortality charges (in some cases to many multiples of the prevailing CSO tables for standard risks) for the purpose of increasing the investment orientation of contracts under section 7702.[12] Also, 1980 CSO became the prevailing commissioners' table in 1984 and thus, taking into account the three-year transition rule of section 807(d)(5), use of 1980 CSO rather than 1958 CSO became mandatory under the then newly enacted reasonable mortality charge rule of section 7702(c)(3)(B)(i) for contracts issued on or after Oct. 21, 1988 (the effective date of the legislation).[13] Since this effective date did not correspond with state law transitions to 1980 CSO, the Service provided effective date relief in Notice 88-128 for 1958 CSO contracts if certain requirements were met in the case of contracts "issued" on or before Dec. 31, 1988. This relief was needed immediately upon TAMRA's enactment in

order not to disrupt sales of contracts. This timing problem in part accounts for the industry's request for and the Service's provision of the guidance only a month after passage of the legislation. At the same time, Notice 88-128 was intended to be temporary measure, since section 5011(c)(1) of TAMRA had directed the Secretary of the Treasury to issue regulations interpreting the reasonable mortality charge requirements by Jan. 1, 1990.[14] Against this backdrop, it is not surprising that the Service applied a stringent material change standard in order to limit the relief provided by the Notice.

While the policy rationale for applying a stringent material change rule as a temporary measure under quick turnaround guidance is understandable, there is far less justification for imposing such treatment as a permanent rule. Changes in mortality tables are unlikely to be the principal (or even a material) motivation underlying a policyholder's request for a change in the terms or benefits of his or her contract. Also, changes in mortality tables are incremental in nature, reflect changing characteristics of the population at large, and may involve either improving or worsening mortality. Further, new mortality tables do not reflect a new Congressional enactment (with a new rule to apply to newly issued contracts and with a grandfather rule to protect existing contractual relationships); rather, changes in the prevailing mortality table occur as a result of action by the National Association of Insurance Commissioners and the states to reflect changes in the population's mortality and state regulation of insurance.

Also, and perhaps more importantly, it is somewhat far-fetched to say that policyholders are motivated to alter their insurance coverage due to a change in the prevailing mortality table, and this seems doubly true where coverage is being decreased. Instead, what they care about is whether they will be able to make a change that they might desire for non-tax-motivated reasons, and in this regard PLR 201230009, if it is correct, presents a substantial obstacle. For example, for a 1980 CSO contract purchased in the mid-1980s, the insurer may have routinely permitted certain changes that are not made pursuant to contractual rights (but which may reflect the insurer's usual business practices) and may have continued to do so after 2008. Under the Service's rationale in the PLR, however, the insurer seemingly would no longer be allowed to pursue such practices, even though no tax motivation would be associated with a change.

RELATIONSHIP BETWEEN NOTICE § 5 AND THE ADJUSTMENT RULE OF SECTION 7702(f)(7)(A)

Despite the above considerations, DEFRA's material change standards were incorporated into later guidance—*i.e.*, Notice 2004-61 and Notice 2006-95—regarding the transition from one mortality table to the next. Notice 2006-95's safe harbors provided welcome clarification that many types of routine changes pursuant to the terms of a contract would not result in a deemed new issuance of a contract, which was of some concern given Notice 88-128's use of the DEFRA material change standards and ambiguities regarding the manner in which those standards should apply. At the same time, the retention of the underlying structure based on DEFRA's material change standards was both unnecessary and problematic. Congress adopted a specific statutory rule as part of section 7702—*i.e.*, the adjustment rule of section 7702(f)(7)(A)—to address changes in the terms and benefits of contracts, and there is no reason to believe Congress intended for that rule to apply only to changes requested by the policyholder pursuant to a contractual right.[15] Such a limited application of the adjustment rule seems, however, to underlie the Service's application of Notice 2006-95.

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To highlight the conflict with the adjustment rule, it is informative to consider the proper treatment of changes under a life insurance contract that are not made pursuant to the terms of a contract where no change of prevailing mortality tables is involved. For example, if a 1980 CSO contract was issued in 1989 and then such a change (*e.g.*, a reduction in death benefit not pursuant to a contractual right) was made in 2006, should "new issue" treatment have been accorded to the contract so that wholly new guideline premiums based on the insured's attained age in 2006 should apply? We think it would be very difficult to support such a view, since the adjustment rule of section 7702(f)(7)(A) is the specific statutory rule that Congress adopted to address the effect of such a change [16] and because section 7702's legislative history prescribes use of the so-called attained-age decrement method as the "proper adjustment" for death benefit decreases under this rule.[17]

CONTINUED ON **PAGE 16**

If this is correct, then should a different treatment apply to contracts if there happens to be a change in the prevailing mortality tables? On what basis would "new issue" treatment apply rather than the statutorily required application of the adjustment rule, apart from the fact that most insurers currently strive to comply with the safe harbors of Notice 2006-95 and thus they conform their practices to the requirements of those safe harbors? It would be odd—and probably unworkable—to conclude that a contract has one "issue date" generally under section 7702 but a different one for purposes of interpreting this term as used in section 7702(c)(3)(B)(i). Ultimately, we think a contract should be viewed as having a single "issue date" for purposes of section 7702, including as this term is used in section 7702(c)(3)(B)(i).

Many insurers have avoided the conflict between the adjustment rule and the DEFRA legislative history's material change standard as incorporated into Notice 2006-95 by ceasing to permit changes that are not pursuant to contractual rights, thus rendering the conflict moot. In our view, this was a result Congress never intended—rather, we think Congress contemplated that all changes would be accounted for under the adjustment rule and, necessarily, this means that such changes would not result in "new issue" treatment under the statute, since in that event the adjustment rule would not apply. The propagation of the DEFRA legislative history's material change standard in Notices after Notice 88-128 explains how this conundrum arose. At the same time, we think the rules can be reconciled in a manner that protects the interests of the fisc while also allowing non-tax-motivated transactions under life insurance contracts that can be, and in our view were intended to be, addressed by the adjustment rule.

ADDITIONAL RATIONALE FOR PERMITTING DECREASES IN BENEFITS

While application of "new issue" treatment and the adjustment rule are mutually exclusive, the practical tension between these two treatments in connection with the reasonable mortality charge rule would be substantially ameliorated by clarifying that the adjustment rule takes precedence for purposes of applying Notice 2006-95 in circumstances where the change does not involve utilization of the prior table to increase a contract's investment orientation. In the case of a decrease in death benefit (*i.e.*, where the pre-change death benefit and other contract values are already based on the prior table), there is no such utilization and, thus, there is no policy reason for applying any treatment other than the statutorily prescribed adjustment rule. Thus, we think § 5 could be construed reasonably such that decreases in death benefits are governed by the adjustment rule of section 7702(f)(7)(A) and that the DEFRA legislative history does not operate to require "new issue" treatment in this circumstance.

The DEFRA legislative history supports this conclusion. In particular, section 7702 as originally enacted included a special rule treating benefit reductions as exchanges for a limited purpose (so that distributions would be taxable under the boot rule of section 1031(b)), but the DEFRA legislative history clarifies that such exchange treatment does not apply for purposes of the effective date rule for section 7702. Specifically, the DEFRA Bluebook states: "The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts ...; Thus, section 7702 will not become applicable to a contract that was issued before January 1, 1985, because a reduction of the contracts [sic] future benefits resulted in the application of this adjustment provision."[18] This legislative history confirms that Congress did not contemplate that reductions in benefits would result in a newly "issued" contract. In the context of PLR 201230009, it thus seems that the Service could have reached a favorable result based on

§ 5.01 of Notice 2006-95, since it follows the DEFRA legislative history's material change standard, including this discussion of benefit reductions.[19]

LIMITED OPTIONS FOR INSURER SELF-HELP

For many life insurance contracts, the precise issue presented in PLR 201230009 is inapplicable since the contracts include express rights to decrease the amount of coverage. For contracts like the ones involved in the ruling, however, a further question is whether there is an opportunity to avoid the problem, such as by engaging in a section 1035 exchange for a smaller 2001 CSO life insurance contract. In some cases, this avenue may be available, but in others a number of obstacles may preclude this possibility, especially for ordinary whole life insurance. For example, if the original and new whole life contracts have fixed periodic premiums, the new contract's premiums may be based on the insured's higher attained age, and thus the desired premium reduction may not be available to the extent the policyholder might desire. Also, the existing contract's cash value will need to be applied to the new contract, which may only be possible if the new contract permits "dump-ins" of premiums beyond the otherwise applicable fixed premiums, *e.g.*, through a paid-up additions rider. In addition, for all types of contracts, cash value may need to be distributed in connection with the exchange in amounts significantly greater than would have applied if the reduction could have been made to the existing contract. Such distributions may be subject to surrender charges and taxable as "boot." The new contract also may provide for surrender charges, expressly or implicitly, and the insurer may not even offer a comparable form anymore that is acceptable to the policyholder. Finally, since there would often be an increase in net amount at risk, the insurer may need to insist on re-underwriting the insured as a condition to allowing the exchange. For these and other reasons, use of an exchange to accomplish a decrease in death benefit is at best cumbersome.

Other avenues for self-help can be undertaken for newly issued contracts with an eye toward future changes in the prevailing mortality tables. In particular, insurers should strive to incorporate into their contracts express terms to govern all of the types of contract modifications they can reasonably foresee. This may be an attractive solution for many insurers. For existing 1980 CSO and older contracts, however, no such self-help is possible, and it thus appears that an insurer's only recourse if it wants to permit changes that are not pursuant to contractual rights is to forgo the protection of Notice 2006-95's safe harbors. Such a step should not be taken lightly, however, since the application of the reasonable mortality charge rule without regard to the Notices is unclear and, at least in some cases, use of the safe harbors is the only way to comply with the statute.[20]

FINAL THOUGHTS

While private letter rulings are not precedential, insurers naturally are very concerned about the stance of the Service in PLR 201230009 and also about the potential that the rationale that seems to underlie the PLR would be more broadly applied. The ruling appears to offer homage to general material change principles under the tax law while ignoring the fact that Congress has prescribed a specific approach for addressing contract changes through enactment of the adjustment rule. Also, the ruling applies an overly rigid interpretation of § 5 of Notice 2006-95 which appears to disregard the policy consideration involved in the transition from one prevailing table to the next. We believe that the Service appreciates the policy arguments in favor of allowing decreases in benefits, but felt compelled to rule as it did in order to follow what it took to be the literal requirements of Notice 2006-95. Hopefully, the Service will modify its position on the PLR and, in all events, there is good reason to revisit (and either dispose of or substantially limit) the use of the DEFRA legislative history's material change standard once future published guidance on transition to new prevailing mortality tables is issued.[21] In the meantime, insurers will need to grapple with the conundrum presented by PLR 201230009. ◂

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END NOTES

1. 2006-2 C.B. 848.
2. Except as otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended.
3. The ruling states that the "Contracts do not include a provision that explicitly contemplates the owner's ability to request a decrease in coverage under the contract" and that the "Contracts do not contain any terms that operate to alter … the amount of coverage." The ruling also states that the decrease in death benefit "neither occurs automatically upon the satisfaction of a condition set forth in the Contracts nor as a result of the exercise of any contractual right provided to a party to the contract." From these statements, and especially the last one, it appears that the policyholders had no contractual right to decrease death benefits, either pursuant to an explicit provision in the contracts or otherwise under state law.

CONTINUED ON **PAGE 18**

END NOTES CONT.

[4] 1988-2 C.B. 540.

[5] The reasonable mortality charge rule also can be satisfied by meeting an interim rule set forth in § 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 ("TAMRA"), which treats 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)."

[6] The "Bluebook" covering the enactment of section 7702 explains that "… the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed." Staff Of The J. Comm. On Tax'n, 98th CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 655 (Comm. Prt. 1984) ("DEFRA Bluebook").

[7] *See* S. Prt. No. 98-169, VOL. I, at 579 (1984) (the "DEFRA Senate Report"); DEFRA Bluebook, at 656.

[8] The ruling earlier stated that: "Taxpayer requests a ruling that a reduction in the face amount under a Contract pursuant to the owner's request and with Taxpayer's consent, will not cause the Contract to be treated as 'newly issued' for purposes of § 5 of Notice 2006-95." In view of phrasing of the taxpayer's request, it is unclear why the ruling speaks in terms of the effect of the change under the statute rather than under the Notice. The Notice principally provides safe harbors for satisfying the reasonable mortality charge rule rather than comprehensive guidance on the rule, and on its face, § 5 of the Notice applies only for purposes of the Notice.

[9] It usually will not be feasible to allow a change if the consequence is application of a new mortality table under section 7702. For example, in the case of fixed premium contracts with mortality guarantees based on 1980 CSO, minimum nonforfeiture values generally would exceed those permissible under the cash value accumulation test if that test has to be applied using 2001 CSO.

[10] Notice 2006-95 does not address the transition that eventually may be needed to a post-2001 CSO table, and thus one can anticipate that further published guidance from the Service will be needed to clarify how such a transition applies.

[11] *See* section 6110(k)(3).

[12] The TAMRA House Report explains Congress' motivation as follows: "Concerns have been raised that some insurance companies are taking aggressive positions with respect to mortality and expense charges. Specifically, companies may be overstating mortality and expense charges and then rebating them to policyholders, or not charging the stated amounts. By overstating mortality and expense charges, insurance companies can increase the investment orientation of life insurance products, contrary to the intent of Congress when the definition of life insurance was enacted." H.R. Rep. 100-795, at 545 (1988).

[13] TAMRA section 5011(a).

[14] The Service and Treasury Department issued proposed regulations on reasonable mortality charges in 1991, but no final regulations have ever been issued. *See* 56 Fed. Reg. 30718 (July 5, 1991). Interestingly, those proposed regulations did not include any material change rule that would deem a contract to be newly "issued" (nor was there any request for comments in this regard).

[15] In discussing circumstances where the adjustment rule would apply, the DEFRA Senate Report (at p. 577) states: "Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time." Also, for purposes of applying this rule to the calculation of guideline premiums, that Report (also on p. 577) notes that "no adjustment shall be made if the change occurs automatically due, for example, to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or due to changes initiated by the company." There is no indication in the legislative history that changes requested by the policyholder that are not made pursuant to a contractual right were excluded from the scope of the adjustment rule.

[16] A tenet of statutory construction is that more specific statutory rules govern over more general rules. *See*, *e.g.*, Fourco Glass Co. v. Transmirra Products Corp., 353 U.S. 222, 228 (1957) (citations omitted) ("However inclusive may be the general language of a statute, it will not be held to apply to a matter specifically dealt with in another part of the same enactment."); CRS Report for Congress: Statutory Interpretation: General Principles and Recent Trends, at CRS-10 (March 30, 2006).

[17] On its face, the DEFRA legislative history's discussion of material changes applies only for the purpose of determining whether a contract issued prior to 1985 becomes subject to section 7702 by reason of a material change in the contract's terms or benefits that is not made pursuant to an option in the pre-DEFRA contract. Thus, apart from the Service's adoption of those DEFRA standards for purposes of the reasonable mortality safe harbors, such standards have no application to a contract that is already subject to section 7702. (Our commentary herein assumes that a change does not cause a contract to be viewed as new under state insurance and contract law.)

[18] DEFRA Bluebook, at 654.

[19] While not directly applicable, we note that final regulations issued with respect to the Jan. 1, 1997 effective date of section 7702B, which defines "qualified long-term care insurance contract," provided that reductions in coverage (with corresponding reductions in premiums) made at the request of the policyholder would not result in "new issue" treatment for purposes of the effective date. We recognize that the Service distinguished the material change rules for this effective date from those applicable for life insurance due to differences in the investment orientation of such contracts. However, in the case of transactions such as reductions in death benefits that are undertaken without a tax motivation, seemingly the same policy conclusion that the Service and Treasury Department reached in those final regulations should apply in the life insurance context as well. We note that application of the adjustment rule will automatically require a return of funding under heavily funded contracts, which serves a purpose comparable to the reduction in premium requirement of the section 7702B regulations.

[20] On this latter point, we note that section 7702(c)(3)(B)(i) requires use of mortality charges not exceeding ones based on the 2001 CSO tables in the case of contracts issued after Dec. 31, 2007, but that Notice 2006-95 permitted continued use of 1980 CSO for contracts issued during 2008. It appears that this extension of the ability to use 1980 CSO only applies if the contract is not treated as newly issued under § 5 of the Notice.

[21] Notice 2006-96 does not purport to address the transition from 2001 CSO to any future prevailing mortality table.