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Product Tax Implications of the Adoption of the 2017 CSO Tables

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The National Association of Insurance Commissioners (NAIC) has adopted a fundamental change in approach for establishing valuation standards for life insurance products that will significantly alter the process for recognition of new mortality tables, due in large part to the advent of principle-based reserving. This change in approach was initiated by the NAIC's 2009 adoption of revisions to the Standard Valuation Law,[1] which was then followed in December 2012 by its adoption of the Valuation Manual, a technical how-to-guide with specifics that will allow actuaries and senior management of companies to implement principle-based reserving. After a lengthy state approval process, requiring adoption by a supermajority of NAIC jurisdictions (*i.e.*, at least 42 jurisdictions, with eligible jurisdictions including the states, D.C., and certain territories) representing 75 percent of direct written premium, the Valuation Manual is now scheduled to become operative on Jan. 1, 2017.

> [T]he most important and pressing need is for IRS guidance that provides a safe harbor for use of the 2017 CSO Tables…

The Valuation Manual changes the process used by the NAIC and states for adopting new mortality tables. In the past, new mortality tables were recognized by regulation. For example, for the 2001 Commissioners' Standard Ordinary (CSO) Mortality Tables (the 2001 CSO Tables), the NAIC adopted a regulation in 2002 titled *Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation* (the 2001 CSO Model Regulation),[2] which provided both a permitted date (based on state adoption) and a required date (Jan. 1, 2009) for its use. The 2001 CSO Model Regulation required individual state approval, and thus there was a lengthy approval process before a majority of the states had adopted the 2001 CSO Tables. (As discussed in more detail below, to be a prevailing table for tax purposes, at least 26 states must permit use of the table.)

Under the new approach, new mortality tables will be adopted by the NAIC via amendments to the Valuation Manual without the need for state legislation or a separate state regulatory process, significantly shortening the duration of the process for introducing new mortality tables.[3] In particular, the Valuation Manual as presently adopted generally contemplates that such amendments would automatically take effect, and thus a change in mortality tables would be implemented based on the effective date of the Valuation Manual amendment without the need of any state action. The 2017 Commissioners' Standard Ordinary Mortality Tables (the 2017 CSO Tables) are the first mortality tables following the new adoption process, under which the NAIC adopted amendments to the Valuation Manual in 2015 recognizing the 2017 CSO Tables for both valuation and nonforfeiture purposes with a Jan. 1, 2017 permitted use date and a Jan. 1, 2020 mandatory use date.[4]

This article is part 1 of a two part series addressing product tax implications of the adoption of the 2017 CSO Tables. Part 1 describes the mortality requirements of sections 7702 and 7702A of the Internal Revenue Code (IRC), which define the terms "life insurance contract" and "modified endowment contract" for federal tax purposes, respectively, and guidance from the Internal Revenue Service (IRS) on this subject. It then highlights the need for new IRS guidance relating to the 2017 CSO Tables. Finally, part 1 concludes with a discussion of the impact of the 2017 CSO Tables on the funding limitations under sections 7702 and 7702A.

Part 2 will discuss guidance issued by the IRS on the 2017 CSO Tables, which is expected later this year or in early 2017.

MORTALITY CHARGE REQUIREMENTS UNDER IRC SECTIONS 7702 AND 7702A

Section 7702, which was enacted in 1984 by the Deficit Reduction Act of 1984 (DEFRA),[5] imposes funding limitations on life insurance contracts. These limitations serve to restrict the allowable premiums and/or cash values for a qualifying life insurance contract. At the heart of the limitations are actuarial limits that are based on a mortality assumption with respect to the underlying insured. To address a problem of manipulation that arose after DEFRA, in 1988 Congress enacted the reasonable mortality charge rule through an amendment to section 7702(c)(3)(B)(i), which placed limitations on the allowable mortality that can be taken into account in calculating guideline premiums for contracts subject to the guideline premium test and net single premiums for contracts subject to the cash value accumulation test.[6]

The reasonable mortality charge rule requires the 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.” The change in mortality requirements from a prescriptive basis to one based on a reasonableness standard added to the complexity that companies face in the design, development, and ongoing administration of life insurance contracts with the section 7702 requirements. The discussion that follows provides additional detail and commentary around the reasonable mortality standards currently applicable for purposes of sections 7702 and 7702A.

The Permanent Mortality Rule

The reasonable mortality requirements can be viewed as having both a *permanent rule* and an *interim rule*, the satisfaction of either of which is sufficient. The *permanent rule* refers to the specific statutory language in section 7702(c)(3)(B)(i), as set forth above. While requiring that mortality charges used in section 7702 (and by cross-reference under section 7702A) be “reasonable,” the statute does not provide any guidance on how reasonableness should be determined, except in two respects. First, the statute delegates authority to the Department of the Treasury to prescribe regulations to address the meaning of “reasonable mortality charges.” Second, the permanent rule clarifies that reasonable mortality charges cannot exceed the rates in the prevailing commissioners’ standard table at the time a contract is issued unless authorized by regulations.[7]

Section 5011(c)(1) of TAMRA directed the Secretary of the Treasury to issue regulations under section 7702(c)(3)(B)(i) by Jan. 1, 1990, setting forth standards for determining the reasonableness of assumed mortality charges. In response, proposed regulations were issued in 1991, but to date have not been finalized. As a consequence, the permanent mortality rule is ambiguous with respect to the meaning of “reasonable mortality charges” but does limit assumed mortality charges to 100 percent of the prevailing commissioners’ standard tables in effect on the issue date of the contract. Thus, under the permanent mortality rule, reasonable mortality will be limited to the 2017 CSO Tables for contracts issued after the three year transition period provided by section 807(d)(5)(B), *i.e.*, after Dec. 31, 2019.

THE PREVAILING COMMISSIONERS STANDARD TABLE

The concept of the prevailing table as a limitation on the reasonableness of mortality was borrowed from the rules in life insurance company taxation governing the deductibility of life insurance reserves. Under section 807(d)(5), which places a limitation on the mortality that may be assumed in the computation of deductible life insurance reserves, the prevailing commissioners’ standard table generally is defined as the most recent commissioners’ standard table prescribed by the NA C 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. At the time the reasonable mortality standards were added to section 7702, 1980 CSO was the prevailing commissioners’ standard table. Therefore, under the *permanent rule*, 100 percent of the sex distinct 1980 CSO Tables generally provided an upper bound on reasonable mortality for contracts issued at that time.

The 2001 CSO Tables replaced the 1980 CSO Tables as the most recent standard table prescribed by the NA C once these new tables were adopted by 26 states in July 2004, and the effective date for use of the new tables was dictated by the section 807(d)(5)(B) three year transition rule. More recently, in 2015, the NA C adopted amendments to the Valuation Manual that would permit the use of new mortality tables *i.e.*, the 2017 CSO Tables beginning Jan. 1, 2017. With the necessary state legislation or regulations already in place to make the Valuation Manual operative on Jan. 1, 2017, the 2017 CSO Tables will be a new prevailing commissioners’ standard table on Jan. 1, 2017.

To allow companies to transition to a new prevailing table, section 807(d)(5)(B) includes a rule that generally allows for the continued use of the old prevailing table for a three year period following the effective date of the new prevailing table, *i.e.*, with permitted use of either the 2001 CSO Tables or 2017 CSO Tables for contracts issued from Jan. 1, 2017 through Dec. 31, 2019, and with the 2017 CSO Tables being mandatory thereafter.

The Interim Mortality Rule

In the 1988 legislation, Congress also provided an interim rule for contracts issued on or after Oct. 21, 1988, but before the effective date of temporary or final regulations on the reasonable mortality standards. 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 regulations have yet to be issued, the interim rule remains in effect. Thus, a contract can satisfy the reasonable mortality requirements of section 7702 either by satisfying the permanent rule or the interim rule.

Similar to the permanent mortality charge rule, the interim mortality rule presents an imprecise standard that is dependent on the interpretation of a legal phrase—in particular, whether charges assumed "differ materially" from those actually expected to be imposed. Thus, for whichever of these rules is used, it is necessary to apply an imprecise legal standard to define the mortality assumption that will be used by rules-based tests and administration systems that rely on actuarial values for measuring compliance. The life insurance industry has expressed its concerns to the IRS over the ambiguity in both the permanent and interim rules. Given the long-term nature of life insurance contracts and their associated guarantees, concern has especially focused on any possible rules or interpretations that could require use of actuarial limitations based on expected current mortality charges. In light of these considerations, and also in view of the consequences of noncompliance, the industry has sought guidance in the form of safe harbors (discussed below) that generally allow the use of 100 percent of the prevailing tables for contracts covering standard risks. Use of these tables was believed to be necessary, for example, to provide some certainty that traditional contracts tested under the cash value accumulation test would satisfy the requirements of both section 7702 and the Standard Nonforfeiture Law for life insurance contracts.

IRS GUIDANCE ON THE REASONABLE MORTALITY REQUIREMENT

Pre-2001 CSO Era Guidance

In the aftermath of the 1988 enactment of the reasonable mortality charge requirements by TAMRA, the IRS issued Notice 88-128,[8] which previewed anticipated future rules and responded to the industry's request for safe harbor guidance; this notice was then followed several years later with the issuance of proposed regulations by the IRS.[9] As one safe harbor, Notice 88-128 provided 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." The notice does not expressly discuss the smoker-distinct versions of the tables, although seemingly they are encompassed by this safe harbor.[10] The notice does speak, however, to the unisex version of the tables, providing 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." This left voluntary use of the unisex versions of the table unaddressed, although seemingly the safe harbor should apply at least where federal law requires use of unisex tables.[11]

As noted, in 1991 the IRS issued proposed regulations to define reasonable mortality charges for use in computations under sections 7702 and 7702A. The proposed regulations were controversial, have never been finalized, and thus are not in effect. As a general rule, the proposed regulations defined reasonable mortality charges as "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."[12] This standard is similar to that of the reasonable expense charge rule of section 7702(c)(3)(B)(ii), despite the substantially different statutory rules prescribed by the two statutes. While Congress adopted a standard for expenses based on expectation of payment, mortality charges are inherently different in that the prevailing table establishes a fixed and ascertainable benchmark. This characteristic of the prevailing table, and other industry arguments demonstrating the compelling need for a conservative assumption in light of the long-term nature of life insurance contracts, was given short shrift by the IRS in its establishment of this general rule, although this harsh rule was ameliorated to a degree by the proposed regulations' inclusion of more generous safe harbors. One such safe harbor generally allowed for use of the 1980 CSO Tables, and smoker-distinct and gender-blended rates also were authorized if certain conditions are met, including consistent use of tables for a plan of insurance.

2001 CSO Era Guidance

The 2001 CSO Tables were adopted by the NAIC in December 2002 and became the prevailing table in July 2004 after adoption by 26 states. Thus, at this time the 2001 CSO Tables replaced the 1980 CSO Table as the most recent standard ordinary mortality table prescribed by the NAIC. With the adoption of the 2001 CSO Tables came the need for IRS guidance on several fronts. Most significantly, there was need for an update to the safe harbors contained in Notice 88-128, since the industry again wished to avoid reliance on the imprecise standards of the permanent and interim mortality charge rules. There was also interest in guidance on the interaction between the 2001 CSO Tables' terminal age of 121 and the computational rule of sec-

tion 7702(e)(1)(B), which requires the maturity date assumption for purposes of section 7702 to be no later than the insured's age 100. Whereas Notice 88-128 had been issued soon after TAMRA's enactment in reflection of the effective date of the statute's reasonable mortality charge rule, the IRS engaged in a lengthier process that involved seeking industry comments in providing guidance for the transition to the 2001 CSO Tables.

The first step in this process was the IRS's issuance of Notice 2004-61,[13] which provided a set of safe harbor rules similar to those contained in Notice 88-128 and were intended to enable an orderly transition to the new 2001 CSO Tables. The safe harbors under this notice addressed both 1980 CSO contracts and 2001 CSO contracts, permitting each set of tables to be used under section 7702 and 7702A in specified time periods. Then, reacting to industry comments concerning some uncertainties raised by this notice, the IRS issued Notice 2006-95,[14] which reiterated the prior notice's safe harbors but made some helpful clarifications.[15] According to its terms, Notice 2006-95 "supplements" Notice 88-128 and "modifies and supersedes" Notice 2004-61.

Notice 2006-95, like its 2004 predecessor, provides safe harbors for contracts based on both the 1980 and 2001 CSO Tables. These safe harbors provide that a mortality charge will satisfy the requirements of section 7702(c)(3)(B)(i) so long as the conditions of the applicable safe harbor are satisfied. The notice's 1980 CSO safe harbor essentially continues the Notice 88-128 safe harbor for 1980 CSO contracts, but recognizes a sunset date of Dec. 31, 2008 to correspond with the Jan. 1, 2009 required date for use of the 2001 CSO Tables in the NAICs model regulation. Notice 2006-95 then provides an additional safe harbor for 2001 CSO contracts under which a mortality charge is treated as meeting the reasonable mortality charge rule if:

- the charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO Tables;
- the charge does not exceed the mortality charge specified in the contract at issuance;[16] and
- either the contract is issued after Dec. 31, 2008, or the contract is issued before Jan. 1, 2009, in a state that permits or requires the use of the 2001 CSO Tables at the time the contract is issued.

This 2001 CSO safe harbor reflects the 2001 CSO Model Regulation's required use of the 2001 CSO Tables for valuation and nonforfeiture purposes for contracts issued on and after Jan. 1, 2009. In adopting this effective date structure, Notice 2006-95 helps avoid an inconsistency between tax requirements under section 7702 and state nonforfeiture law requirements.[17]

Material Change Rules

One aspect of the IRS's safe harbors contained in all three notices is the inclusion of special rules that treat a contract as newly issued for purposes of the safe harbors if certain types of changes are made to a contract. These material change rules serve to limit the scope of contracts that can take advantage of the safe harbors. They also have had the perhaps unintended effect of altering the manner in which some insurers administer their blocks of insurance in force. In particular, insurers now are often reluctant to allow changes to contracts in the absence of an express contractual right if new issue treatment would result in loss of safe harbor protection, even though the insurer may have maintained a long-standing practice of permitting those types of changes. As discussed below, a key question for future IRS guidance is whether modification of this material change rule is appropriate, especially in that it is difficult to reconcile with

the statute (including the adjustment mechanism contained in section 7702) and in this context appears to serve little if any tax policy purpose.

The material change rules of Notice 2006-95 begin by providing that the issue date of a contract should be determined "according to the standards that applied for purposes of the original effective date of § 7702."[18] The notice then elaborates by observing that new issue treatment is accorded to exchanges of contracts and that "a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (that 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."[19] Section 5.02 of Notice 2006-95 then provides that,

> "[n]otwithstanding section 5.01, if a life insurance contract satisfies [the 1980 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 nonforfeiture laws; and (3) the contract continues upon the same policy form or blank." [Emphasis added.]

Finally, section 5.03 of Notice 2006-95 offers examples of changes that pursuant to section 5.02 would not result in new issue treatment of a contract. Specifically, Notice 2006-95 section 5.03 states:

> "The changes, modifications, or exercises of contractual provisions referred to in section 5.02 include (1) the addition or removal of a rider; (2) the addition or removal of a qualified additional benefit (QAB); (3) an increase or decrease in death benefit (whether or not the change is underwritten); (4) a change in death benefit option (such as a change from an option 1 to option 2 contract or vice versa); (5) reinstatement of a policy within 90 days after its lapse; and (6) reconsideration of ratings based on rated condition, lifestyle or activity (such as a change from smoker to nonsmoker status)."

Since section 5.03 of the notice provides examples (rather than a substantive rule) and references "changes, modifications, or exercises of contractual provisions" under section 5.02 of the notice, it appears necessary that the criteria of section 5.02 of the notice be met in order for a transaction to fall within the ambit of the examples identified in section 5.03 of the notice. Thus, for example, there must be a contractual right to add a particular rider in order for the addition of the rider not to trigger new issuance treatment for purposes of the notice.[20] Similarly, if a contractual right exists, is exercised, and the criteria of section 5.02 of the notice is otherwise satisfied, then the transaction would not trigger new issuance treatment, even though the transaction

AGE 100 METHODOLOGIES

With the adoption of the 2001 CSO Tables, the life insurance industry had, for the first time, a standard mortality table that extended beyond the insured's age 100. This raised a question around how the computational rules in section 7702(e) should apply, and more broadly, around how the actuarial tests under both sections 7702 and 7702A apply after age 100. Through a collaborative process between the IRS and the insurance industry, many of the questions were answered. Building on the work of the 2001 CSO Maturity Age Task Force of the Taxation Section of the Society of Actuaries, the IRS published proposed "safe harbor" rules in 2009 (Notice 2009-47) followed by a final safe harbor in 2010 (Revenue Procedure 2010-28).

More specifically, in 2005 the SOA's Taxation Section established a 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 report was published in 2006, and the final IRS safe harbor closely followed the recommendations in the report. Revenue Procedure 2010-28 expressly acknowledged these recommendations and cited to the publication of the report in the Taxation Section's newsletter, *Taxing Times*. In introducing its safe harbor rules, the revenue procedure states that the IRS "would not challenge" the qualification of a life insurance contract as meeting the requirements of section 7702 or "assert" that a contract is a modified endowment contract (by failing under section 7702A) if the contract satisfies the requirements of the statutes using all of the "Age 100 Safe Harbor Testing Methodologies." These methodologies detail the manner in which the various calculations under section 7702 and 7702A should be performed in order to fall within the safe harbor's ambit. The guiding principle of these methodologies is that calculations under sections 7702 and 7702A must abide by the statutory computational rule that restricts the deemed maturity date to no later than the insured's age 100. This is the case even if, for example, the result is a 6-pay premium under section 7702A in the case of a material change at the insured's age 94.

may not be listed among the examples in section 5.03 of the notice, *e.g.*, a reinstatement pursuant to a contractual right after the 90 day period referenced in section 5.03 of the notice.

THE NEED FOR IRS GUIDANCE FOR THE TRANSITION TO THE 2017 CSO TABLES

Need for a New Safe Harbor is Time Sensitive

Given that the 2017 CSO Tables are available for use for contracts issued on and after Jan. 1, 2017, the most important and pressing need is for IRS guidance that provides a safe harbor for use of the 2017 CSO Tables for purposes of calculations under sections 7702 and 7702A. In that insurers are, with reason, wary of the imprecise standards articulated by the permanent and interim mortality rules and must necessarily adopt specific mortality assumptions for these calculations, it would be most helpful if this guidance could be issued prior to the Jan. 1, 2017 effective date.[21]

Need for Reconsideration of Material Change Rule

We also think that the time is ripe for reassessing the role of the material change rules currently incorporated into Notice 2006-95 and encourage inclusion of a revised structure—and one we believe is more in accord with the statute—in new IRS guidance. In the discussion below, we offer thoughts on both technical and tax policy considerations that are relevant to the material change rule issues.

Technical Considerations for Material Change Rule

The application of section 7702 to a contract, and also the identity of the prevailing mortality table within the meaning of section 7702(c)(3)(B)(i), are based on the "issue date"[22] of the contract. The DEFRA legislative history offers some commentary regarding the meaning of a contract's "issue date." This legislative history, in commenting on the effective date rule for section 7702, also indicates that a change to a pre-DEFRA life insurance contract (*i.e.*, generally a contract issued before 1985) can result in new issue treatment of a contract, so that the contract would become subject to section 7702.[23] As previously noted, all three IRS notices providing safe harbors for purposes of the reasonable mortality rule cross-reference the section 7702 effective date standard for identifying a contract's "issue date." At issue is whether this standard is appropriate and should continue.

A troubling consequence of this cross-reference is that it often can create a disconnect between a contract's "issue date" that generally applies for purposes of section 7702 and the "issue date" that applies for purposes of the safe harbor. The purpose of the section 7702 effective date—and especially of its legislative history commentary regarding material changes – was to ensure that taxpayers could not avoid the Congressional purpose in enacting the actuarial requirements of section 7702 by making changes to a pre-DEFRA contract. Thus, for example, an increase in a pre-DEFRA contract's death benefit other than pursuant to a contractual right after the effective date of section 7702 would cause the contract to be newly issued at the time of the increase based on this legislative history, so that the contract would become subject to section 7702 and its actuarial limitations. In contrast, there is no indication in the legislative history that such a change to a post-DEFRA contract (*i.e.*, a contract that is subject to section 7702 when originally issued) would result in a newly issued contract. Instead, such a change seemingly should be addressed by the adjustment rule of section 7702(f)(7)(A), which is the specific statutory rule mandated by Congress to apply in this circumstance.[24] Thus, in this example, the increase in death benefit other than pursuant to a contractual right would not affect the contract's "issue date" that generally applies for purposes of section 7702, but it would result in a change in the contract's "issue date" for purposes of the notice safe harbors.

In most cases, this potential disconnect never arises, since insurers generally strive to satisfy the requirements of the safe harbors and thus often restrict post issuance changes to ones for which there is a contractual right, at least in circumstances where the currently prevailing mortality table at the time of a proposed change differs from the prevailing mortality table at issue. However, a number of conundrums arise where such disconnect does arise. If a transaction causes a contract to be newly issued for purposes of the notice (and assuming the insurer wants to use the safe harbors provided by IRS notices),

an initial key question when a change is made not pursuant to a contractual right is whether the insurer should treat the contract as newly issued for purposes of the entirety of section 7702, despite the points noted above. If so, this arguably would mean that new guideline premiums would be determined for the contract taking into account the insured's current attained age. In this regard, the new attained-age guideline single premium may exceed the previously applicable guideline single premium, thus potentially increasing the contract's investment orientation. Also, in the case of a contract with a low cash value, the effective investment orientation may increase since new issue treatment may allow greater funding of the contract going forward (since that cash value would be the only amount that initially increases "premiums paid" under section 7702(f)(1)). Alternatively, should the adjustment rule of section 7702(f)(7)(A) apply to account for the change, perhaps on the theory that the contract is newly issued solely for purposes of section 7702(c)(3)(B)(i) but not otherwise under section 7702?[25]

Having to deal with the notices' material change rules adds considerable complexity to the administration of life insurance contracts with the requirements of the statutes, which are intricate even without this additional burden. This raises the question, discussed next, of whether any material tax policy goal is being served by the imposition of the notices' material change rules and their departure from section 7702's otherwise applicable adjustment regime.

Tax Policy Considerations for Material Change Rule

Because the provision of a safe harbor is a matter of administrative grace, the IRS is able to impose a material change standard which, as discussed above, departs from the otherwise applicable regime for addressing post-issuance changes to a contract prescribed by section 7702(f)(7)(A). At issue, however, is whether imposition of the material change rules furthers a material tax policy goal. As discussed above, the notices' material change rules cross-reference the effective date rule of section 7702 and its legislative history, and the material change rule that applied for that purpose (as described by the DEFRA legislative history) was intended to prevent taxpayers from avoiding Congress' newly enacted restrictions on life insurance investment orientation. In this respect, the section 7702 effective date rule is similar to many effective date rules that apply to newly enacted provisions of the IRC. Transitions from one prevailing mortality table to another, however, are fundamentally different in nature from a statutory change.

A change from one prevailing mortality table to another is not a circumstance where Congress has acted to preclude or limit a prior practice. Rather, changes in prevailing mortality tables arise from actions taken by the actuarial profession and ultimately the NAIC in recognition of changes in life expectancy for the insured population over time. There is no tax rule dictating the frequency with which mortality tables need to be reevaluated. Further, while changes to the tables in the past have generally reflected improved life expectancy, there is no assurance that this will continue to be the case.[26] One might also reasonably expect that the magnitude of changes in tables over time will become less significant than they have been in the past. Perhaps most importantly, policyholders generally are unaware of changes in prevailing mortality tables. Thus, when policyholders do request changes to their contracts that are not pursuant to an existing contractual right, this action commonly is sought due to considerations having nothing to do with the change in prevailing

mortality tables. Rather, a policyholder may desire lower rates (such as when requesting a change in guaranteed rates) or may desire a change in the level of coverage to address his or her changing needs.

This raises the further consideration regarding the types of changes that commonly implicate the notices' material change rules. For most universal life insurance policies (which by their nature are flexible), contractual rights typically exist for many types of contractual changes, including for increases and decreases in death benefits. For some contracts, there may not be a right to change the mortality guarantees (*e.g.*, from smoker to non-smoker status or dropping of a rating based on improved health). Under the adjustment rule of section 7702(f)(7)(A), such changes would result in a reduction in the contract's guideline premiums or net single premium, *i.e.*, there would be a reduction in investment orientation. Also, addition of a qualified additional benefit is another common change to universal life insurance contracts that often is not made pursuant to a contractual right; however, in that the reasonable expense charge rule applies to account for the charges for such riders,[27] there is little if any opportunity for increasing a contract's investment orientation through the addition of such a rider. Similarly, while whole life insurance contracts are less flexible in nature, insurers may have a practice of allowing certain changes such as a reduction in death benefit even in the absence of a contractual right to do so. Such changes are usually driven by non-tax considerations (such as affordability) and may result in a reduction in the contract's investment orientation after application of the adjustment rule. In each of these instances, there is no material tax policy reason to treat the contract as newly issued.[28]

> [A] key question for future IRS guidance is whether modification of [the] material change rule is appropriate …

It is not clear what policy is achieved by applying the DEFRA effective date material change standard to alter a post-DEFRA contract's "issue date" for purposes of identifying the applicable prevailing mortality table. The standard was put in place due to a concern about abuse involving pre-DEFRA contracts. In the case of a post-DEFRA contract, however, there is little if any opportunity for abuse. The safe harbors of the various notices have provided beneficial clarifications to the industry. However, the tax policy considerations associated with a new statutory enactment are fundamentally different from a change in mortality tables. Thus, the notices' reliance on the section 7702 effective date rule is an aspect of the safe harbors that needs revision.[29]

IMPACT OF THE 2017 CSO TABLES ON THE SECTION 7702 AND 7702A FUNDING LIMITATIONS

Like the 2001 CSO Tables, the 2017 CSO Tables are a collection of mortality tables, varying in structure and risk classification. In total, the Society of Actuaries has published 104 mortality tables, including variations based on the following characteristics:

- Age-last and age-nearest birthday
- Select and ultimate
- Sex-distinct and gender-blended
- Composite and smoker-distinct
- Preferred risk classes for both nonsmoker (three classes) and smoker (two classes) risk classes

The consistency in structure with the 2001 CSO Tables, including a terminal age of 121, will lessen to some extent the administrative burden associated with the transition to the 2017 CSO Tables. This should somewhat ease the burden on those responsible for policyholder administration systems, particularly for those who may have been involved in the transition to the 2001 CSO Tables who had to address then for the first time a mortality table that extended beyond age 100. Even with these considerations in mind, transition to the new tables nonetheless will present challenges and require devotion of substantial resources, especially given the related work involved with implementation of principle-based reserving.

As noted above, by referencing the prevailing table as of a contract's issue date, section 7702(c)(3)(B)(i) has a built-in mechanism for reflecting mortality improvements in the section 7702 funding limitations for newly issued contracts. The 2001 CSO Tables generally resulted in mortality improvements for virtually all risk classes relative to the 1980 CSO Tables, but such improvements varied in magnitude across risk classes, as would be expected. This resulted in across-the-board reductions to guideline premiums, net single premiums, and 7-pay premiums averaging in the 15 to 20 percent range,[30] with marginally higher reductions for males and lower reductions for smoker risk classes. The 2017 CSO Tables will again have a similar effect on the section 7702 and 7702A funding limitations, layering an additional 10 to 15 percent reduction on top of those realized from the transition to the 2001 CSO Tables. Since the enactment of the reasonable mortality requirements in 1988, funding limitations under sections 7702 and 7702A will have experienced reductions in the range of 25 to 35 percent due solely to mortality improvements reflected in prevailing tables.

Companies are now planning their three year strategy for transitioning their product portfolio to become 2017 CSO compliant, *i.e.*, before the Jan. 1, 2020 deadline when use of the 2017 CSO Tables becomes mandatory. Because the 2017 CSO Tables will generate reduced valuation and minimum nonforfeiture values for traditional products such as term and whole life insurance, we would expect companies issuing these products to be early adopters of the 2017 CSO Tables, particularly with respect to their products with lesser investment orientation that benefit from reduced premiums and lower valuation requirements. Issuers of more investment focused nontraditional products like universal and variable universal life that tend to rely on the guideline premium test are likely to wait a little longer. As discussed further below, the 2017 CSO Tables may not be as welcomed for developers and purchasers of such products, particularly for policyholders seeking a greater investment orientation while still desiring lifetime death benefit protection.

The guideline premium test sets forth funding limitations in the form of endowment premiums (single and level premium) that are calculated based on prescribed assumptions for interest, mortality and expenses. In this regard, any experience realized that is more "favorable" than the prescribed assumptions (*e.g.*, mortality charges that are less than those reflected in the calculation of guideline premiums) will increase the likelihood that the policy will generate cash values that allow for maturity of the contract. On the contrary, less favorable experience (*e.g.*, crediting interest at a rate that is less than the interest rate reflected in the calculation of guideline premiums) will reduce the likelihood for such cash value generation. Using the concept of a "margin" to describe differences between actual and prescribed assumptions underlying the section 7702 calculations, the discussion below explores some of the potential consequences that may emerge for guideline premium test contracts based on the 2017 CSO Tables.

While it may take several years or more to reflect mortality improvements in standard industry mortality tables, companies generally respond more quickly in building mortality improvements into their product designs. We would therefore not expect the 2017 CSO Tables to produce significant changes in the operation of universal life insurance contracts, as most companies have already reflected these mortality improvements through reduced current cost of insurance charges for their products. The biggest impact of the 2017 CSO Tables from a product design perspective will likely be in the form of reduced "mortality margins" (*i.e.*, the excess of reasonable mortality charges based on 2017 CSO Tables that are reflected in guideline premiums over the cost of insurance charges currently imposed), which will likely play an important role in a policyholder's ability to fund universal life insurance contracts in today's low interest rate environment.

With the implementation of the 2001 CSO and 2017 CSO Tables, there have been significant corresponding reductions in the magnitude of the mortality margin. As noted above, the combined impact that both the 2001 and 2017 CSO Tables have had on guideline premiums has resulted in a 25 to 35 percent average reduction for many risk classes relative to their 1980 CSO counterparts. To put these reductions in perspective, they are roughly the same magnitude as a 1 percent reduction in the credited rate below the statutory minimum rates of 6 percent for the guideline single premium and 4 percent for

the guideline level premium, *i.e.*, a negative 1 percent interest margin. Put differently, the additional premium required to endow a contract under a negative 1 percent interest margin increases 25 to 50 percent on a single premium basis and 15 to 40 percent on a level premium basis (percentages decease as issue ages increase).

While 1980 and 2001 CSO products likely still have some measurable mortality margin to help offset any negative interest rate margin that currently exists on products crediting less than 4 percent interest, policyholders will likely find it increasingly challenging to fund 2017 CSO guideline premium test contracts, and thus there is a substantially increased risk that contracts will be in an underfunded status in later policy durations even if they have funded their contracts at or near the guideline premium limit. Section 7702(f)(6) provides some relief, by allowing for the payment of premiums to keep a contract in force that would otherwise exceed the guideline premium limitation. However, the additional restrictions imposed by section 7702(f)(6) that prevent the build-up of any cash value makes this an expensive alternative, essentially requiring that the contract be administered as a term insurance policy for as long as the policyholder can afford the coverage.

Companies are likely to respond to these funding concerns by continuing to offer "no-lapse guarantee" features on universal life products that will provide assurances to policyholders that their contracts will remain in force through at least the no-lapse guarantee period, regardless of the underlying performance of the contract's cash value. Companies also may respond by developing universal life products that are designed to comply with the cash value accumulation test, as this design may provide a better long-term funding solution in today's low interest rate environment (since this test does not impose any direct limitation on premiums). However, universal life designs based on the cash value accumulation test are not without their own administrative challenges. First, such contracts require more insurance risk (*i.e.*, net amount at risk, or the excess of the death benefit over the contract's cash value) than their guideline premium test counterparts in the older age durations when mortality costs become progressively more expensive. The other important consideration in a universal life cash value accumulation test design relates to application of the necessary premium test of section 7702A(c)(3)(B)(i). Monitoring compliance with the necessary premium test is required to properly identify when material changes, within the meaning of section 7702A(c)(3), arise and ultimately if and when a contract becomes a modified endowment contract, or MEC, under section 7702A. Given that most universal life insurance contracts on the market today are designed to qualify under the guideline premium test, policyholder administration systems may not currently have the appropriate functionality to support administration of the necessary premium test for flexible premium cash value accumulation test products. This is because the necessary premium test functions in a substantially different manner for such products compared with the test's application to guideline premium test products. While a cash value accumulation test design may ultimately prove to be a better alternative for addressing long term funding concerns, companies will need to tread carefully into the cash value accumulation test realm for universal life and other flexible premium designs and do their due diligence to fully understand the implications and administrative trade-offs for this design.

CONCLUDING THOUGHTS

The new 2017 CSO Tables are upon us, and insurers are already well into the process of evaluating the effects of the new tables on their product portfolios. Action by the IRS in the form of a safe harbor for use of the 2017 CSO Tables will facilitate this transition by providing needed certainty to the industry (and hopefully reconsideration of the material change rules will reduce the burden on insurers associated with administering the requirements of sections 7702 and 7702A). Significantly, the 2017 CSO Tables meaningfully reduce the funding limitations under section 7702 and 7702A, which makes product design even more challenging in the current low interest rate environment. While different design options may help address these funding concerns, they come with their own difficulties which insurers will need to navigate. ■

Note: The views expressed are those of the authors and do not necessarily reflect the views of Davis & Harman or Ernst & Young LLP.

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ENDNOTES

1 MDL-820 (2010).

2 MDL-814 (2003).

3 *See* § 11B and 11C of the Standard Valuation Law and drafting note thereto; § 5cH(6) of the Standard Nonforfeiture Law for Life Insurance, MDL-808 (2014).

4 While the accelerated adoption process provided by the *Valuation Manual* is beneficial from an efficiency perspective, it raises some concerns in that it may not provide sufficient time for companies to develop products and conform valuation and administrative systems to new tables; there also may be less time for the IRS to provide any needed guidance on new tables from both a valuation and product tax perspective. To alleviate some of these concerns, guidance notes were added to VM-02 and VM-20 of the *Valuation Manual* that recommend a timeframe for new table adoption. Interestingly, for the 2017 CSO tables, the permitted use date ultimately adopted did not adhere to this timeframe, due in part to the desire of the NAIC to have the permitted date for the 2017 CSO Tables coincide with the operative date of the *Valuation Manual*.

5 PUB. L. NO. 98-369.

6 *See* § 5011(a) of the Technical and Miscellaneous Revenue Act of 1988, PUB. L. NO. 100-647 (TAMRA), which is effective for contracts entered into on or after Oct. 21, 1988. For earlier issued contracts, the statute permitted reflection of "mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract)."

7 In this regard, the TAMRA legislative history provides 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." H.R. REP. NO. 100-1104, PT. 2, at 108 (1988) (Conf. Rep.).

8 1988-2 C.B. 540.

9 For those readers interested in additional background and a more in depth analysis of the prior mortality table guidance issued by the IRS, we recommend the following *TAXING TIMES* articles: "Life Beyond 100: Rev. Proc. 2010-28 Finalizes the "Age 100 Methodologies" Safe Harbor," Feb. 2011; "IRS Issues Proposed Safe Harbor Prescribing "Age 100 Methodologies,"" Sept. 2009; "More on Reasonable Mortality: IRS Issues Notice 2006-95," Feb. 2007; and "Evolution of Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code," May 2005. *See also* "Life Insurance & Modified Endowment under Internal Revenue Code Sections 7702 and 7702A (2d ed. 2015)."

10 *See* NAIC Model Rule (Regulation) Permitting Smoker/Nonsmoker Mortality Tables for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits, MDL-812 (1984). 1 MDL-820 (2010).

11 *See*, *e.g.*, *Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans, etc., et al. v. Norris, etc.*, 463 U.S. 1073 (1983). *See also* Notice 2006-95, discussed below.

12 Prop. Treas. Reg. § 1.7702-1(b).

13 2004-2 C.B. 596.

14 2006-2 C.B. 848.

15 For example, Notice 2006-95 clarified that an increase in death benefit with underwriting provided pursuant to the terms of a contract would not cause a contract to be treated as newly issued. Also, Notice 2004-61 had expressly permitted the use of smoker-distinct and gender-blended mortality tables, but only if the insurer used such tables consistently for all contracts under a plan of insurance (as foreshadowed in the 1991 proposed regulations on reasonable mortality). Notice 2006-95 retains this consistency requirement, but only for purposes of the 2001 CSO safe harbor so as not to impose retroactively an additional requirement.

16 Notice 2006-95's requirement for the 2001 CSO safe harbor that mortality charges assumed not exceed the mortality charges specified (*i.e.*, guaranteed) in the contract was not a limitation for Notice 88-128's 1980 CSO safe harbor. Thus, in applying the 2001 CSO safe harbor, special care should be taken to ensure that any contractual guarantees of mortality charges less than charges based on 100 percent of the 2001 CSO Tables are reflected in calculations under sections 7702 and 7702A.

17 Taking into account the three year transition rule of section 807(d)(5)(B), the permanent mortality charge rule of section 7702(c)(3)(B)(i) limited mortality charges to those based on the 2001 CSO Tables for contracts issued on and after Jan. 1, 2008. The 2001 CSO safe harbor of Notice 2006-95 extends this effective date, *i.e.*, to contracts issued on and after Jan. 1, 2009, assuming the requirements for use of the safe harbor are met. This latter point is especially significant for contracts based on the 1980 CSO Tables issued during 2008, since use of the 1980 CSO Tables for calculations under sections 7702 and 7702A is only allowed under the permanent mortality rule if the requirements of the safe harbor are met, including the notice's material change rules which are discussed below.

18 Notice 2006-95, section 5.01.

19 *Id.*

20 *See*, *e.g.*, PLR 201230009 (Jan. 30, 2012) (treating a reduction in death benefit under a life insurance contract that was not made pursuant to a contractual right as causing the contract to be newly issued for purposes of § 5 of Notice 2006-95).

21 It also would be useful to confirm that the safe harbor provided by Rev. Proc. 2010-28 for the Age 100 Safe Harbor Testing Methodologies continues to apply for contracts utilizing the 2017 CSO Tables.

22 The Blue Book explanation of DEFRA observes that "[f]or purposes of applying the [effective date of section 7702] … 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…." *See* 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. Print 1984) (DEFRA Blue Book). Also, a footnote to this sentence in the DEFRA Bluebook states that "[t]he use of the date on the policy would not be considered the date of issue if the period between the date of application and the date on which the policy is actually placed in force is substantially longer than under the company's usual business practices." *Id.*

23 *See* S. PRT. NO. 98-169, VOL. I, at 579 (1984) (stating: "Contracts issued in exchange for existing contracts after Dec. 31, 1984 are to be considered new contracts issued after that date. For these purposes a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange"); DEFRA Blue Book at 656 (stating: "The exercise of an option or right granted under the contract as originally issued does not result in an exchange and thus does not constitute the issuance of a new contract for purposes of new section 7702 and any applicable transition rules if the option guaranteed terms that might not otherwise have been available when the option is exercised…").

24 This treatment also accords with section 7702(a), which provides that a "life insurance contract" as defined in section 7702 must constitute a life insurance contract under applicable law (generally state law). Since the contract that is a life insurance contract under applicable law is the foundation to which section 7702's actuarial tests are applied, it follows that if a change does not cause a contract to be treated as a newly issued under state law, it would not be treated as newly issued for purposes of section 7702(a) or otherwise for purposes of section 7702. Of course, if a change did cause the contract to be newly issued under state law, it similarly would be treated as newly issued for purposes of section 7702.

25 Yet another question is how a change not made pursuant to a contractual right should be addressed in circumstances where there has been no change in the prevailing mortality table between the original issuance of the contract and the date of the change. Seemingly, there is no need for new issuance treatment in this circumstance, and the adjustment rule would apply to account for the change. However, the notices' material change rules and their reliance on the section 7702 effective date rule do not expressly distinguish this situation.

26 If a future mortality table generally reflects worsening mortality, and correspondingly allows for greater contract investment orientation under section 7702, one wonders whether the IRS will continue in its viewpoint as expressed in the existing material change rules.

27 *See* Rev. Rul. 2005-6, 2005-1 C.B. 471.

28 Changes to the legal entitlements of a contract can cause the contract to be treated as a new property for tax purposes. *See, e.g., Cottage Savings Association v. Comm'r,* 499 U.S. 554, 565 (1991). However, the applicable law rule of section 7702(a) and the adjustment rule of section 7702(f)(7)(A) prescribe more specific statutory rules to address the meaning of a contract's "issue date" and the effect of changes on the actuarial limitations applicable to a contract.

29 At a minimum, it would be helpful if guidance clarified that various common transactions do not result in new issue treatment of a contract even if not made pursuant to the terms of a contract, such as changes in smoking status and ratings based on improved health, death benefit reductions, the addition of qualified additional benefits, and any change that would not be taken into account in applying the statute's actuarial limitations in any event.

30 For this analysis, the impact of new mortality tables on the section 7702 and 7702A funding limits is based on the calculation of guideline, net single and 7-pay premiums assuming no expenses or charges for qualified additional benefits, and interest at the statutory minimum rate of 4 percent for the guideline level, net single and 7-pay premiums and 6 percent for the guideline single premium. As improvements are reflected in the mortality used to calculate these values, the impact of including expenses (in the case of guideline premiums only) and charges for qualified additional benefits in the calculations will generally serve to increase these values. For most universal life insurance contracts, however, the impact of mortality improvements on the funding limitations from expenses and charges for qualified additional benefits (which results in an increase in the funding limits relative to those under the prior tables) is generally not material relative to the impact that mortality improvements have on death benefits (which results in a decrease in the funding limits relative to those under the prior tables).