



Article from

Taxing Times

February 2017

Issue 13, Vol. 1

IRS Notice 2016-63 – Safe Harbor Guidance for 2017 CSO

By John T. Adney, Craig Springfield and Brian King

The Internal Revenue Service (IRS) recently released Notice 2016-63¹ providing safe harbor guidance for use of the 2017 Commissioners' Standard Ordinary mortality tables (2017 CSO) in calculations under sections 7702 and 7702A of the Internal Revenue Code, which define the terms "life insurance contract" and "modified endowment contract," respectively, for federal tax purposes. The notice's effective dates for permitted and required use of 2017 CSO generally mirror the effective dates of state law that apply for purposes of both valuation and nonforfeiture, *i.e.*, the safe harbor generally permits use of 2017 CSO for contracts issued prior to Jan. 1, 2020, but requires use of 2017 CSO for contracts issued on and after this date. The new notice generally restates the safe harbors Notice 88-128² and Notice 2006-95³ and is effective Oct. 19, 2016.⁴

In an article in the October 2016 issue of *TAXING TIMES*, "Product Tax Implications of the Adoption of the 2017 CSO Tables,"⁵ we discussed the need for IRS guidance to accommodate the development of new life insurance contracts with mortality guarantees based on 2017 CSO. In that article, we also emphasized the need for revisions to the material change rules of prior notices which address when a change in the terms or benefits of a contract will cause it to be treated as newly issued for purposes of the mortality charge safe harbors.

Notice 2016-63 provides helpful and timely safe harbor guidance for use of 2017 CSO. In this regard, insurers designing contracts with mortality guarantees based on 100 percent of 2017 CSO can be certain that use of 2017 CSO in determinations of net single premiums, guideline premiums, and 7-pay premiums under sections 7702 and 7702A will be in accordance with the reasonable mortality charge rule of section 7702(c)(3)(B)(i). Notice 2016-63 also provides useful clarifications of the material change rules, although a fundamental reconsideration of those rules continues to be needed. Regarding these clarifications, the notice provides that if the only change to a life insurance contract is a reduction or deletion of benefits, this change will not in and of itself affect the contract's issue date

for purposes of the safe harbors. The notice also clarifies that a reinstatement pursuant to a contract's terms that is required by applicable state or foreign law will not cause a contract to be newly issued.

BACKGROUND

The determinations under sections 7702 and 7702A of net single premiums, guideline premiums, and 7-pay premiums for contracts issued on and after Oct. 21, 1988, generally must be based on "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" (emphasis added).⁶ Because no final regulatory guidance has been issued on reasonable mortality charges, the prevailing commissioners' standard tables establish a defined upper limit on the mortality charges that satisfy this rule. Under section 807(d)(5)(A), the "prevailing commissioners' standard tables" are the most recent commissioners' standard tables promulgated by the National Association of Insurance Commissioners (NAIC) 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. 2017 CSO became the prevailing commissioners' standard ordinary mortality tables during 2016 when the NAIC adopted the new tables as part of the Valuation Manual under the revised Standard Valuation Law. Taking into account the three-year transition rule of section 807(d)(5)(B), the defined upper limit on reasonable mortality charges under section 7702(c)(3)(B)(i) will become 2017 CSO for contracts issued on and after Jan. 1, 2020.

While the cross-reference in section 7702(c)(3)(B)(i) to the prevailing commissioners' standard tables offers a degree of certainty with respect to the mortality charge assumption that is permissible, considerable uncertainty remains due to the requirement that mortality charges also be "reasonable." This reasonableness requirement could apply to further reduce the mortality charges that may be taken into account under this statutory rule.⁷ It is uncertainty regarding the potential application of this reasonableness requirement, and the severe consequences that could result from a violation, that give rise to the need for safe harbor protection.

In addition to the general question regarding how the "reasonableness" requirement will be applied, a further issue addressed by the various IRS notices on the reasonable mortality charge rule regards the circumstances when a change in the terms or benefits of a contract would cause it to be treated as newly issued for purposes of the notices. Because the reasonable mortality charge rule's application—and thus the identification of the prevailing commissioners' standard table—is based on the issue date of a contract, a change that causes a contract to



be newly issued could cause the contract to become subject to a new prevailing table. If this consequence is not recognized and accounted for by an insurer, the determinations under sections 7702 and 7702A could be erroneous, and failures to comply with one or both of these statutes could be the result.

As discussed in detail in our prior *TAXING TIMES* article referenced above, it is highly questionable whether new issue treatment is appropriate in situations where a change does not result in new contract treatment under applicable law, especially in that both section 7702 and 7702A contain specific adjustment mechanisms that address the effect of a change in a contract's terms or benefits. Notice 2016-63 does not address this general concern, although as mentioned above (and as discussed further below) the new notice helpfully addresses two specific criticisms that had been raised with respect to prior IRS notices on the reasonable mortality charge rule.

NOTICE 2016-63

Notice 2016-63 restates the safe harbors established by Notice 88-128 and Notice 2006-95, and it generally retains the structure and rules of the latter notice, *e.g.*, the rules for use of unisex/sex-distinct mortality tables and for unismoke/smoker-distinct mortality tables. Most significantly, Notice 2016-63 provides a new safe harbor for 2017 CSO, stating that:

A mortality charge with respect to a life insurance contract will satisfy the requirements of § 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2017 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after December 31, 2019, or (b) the contract is issued before

January 1, 2020, in a state that permits or requires the use of the 2017 CSO tables at the time the contract is issued.⁸

With respect to the material change rules that apply for purposes of determining a contract's issue date, Notice 2016-63 also generally retains the structure and rules of Notice 2006-95. Thus, for purposes of the notice, contracts that are received in exchange for existing contracts will generally be treated as new contracts that are issued on the date of the exchange.⁹ Also, similar to Notice 2006-95, the new notice provides 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.¹⁰ Further, section 5.02 of the notice continues the prior rule, with modifications to take account of 2017 CSO, under which:

if a life insurance contract satisfied [a safe harbor of the notice] when originally issued, a change from the previous tables to the 2001 or 2017 CSO tables is not required if: (1) the change, modification, or exercise of a right to modify or add 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 or 2017 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.¹¹

The latter two requirements under this rule pertain to whether a contract is new under applicable law, which is relevant to the applicable law requirement of section 7702(a). The first requirement relating to whether a change is "pursuant to the terms of the contract," however, appears to go beyond the statute, and as articulated in our earlier article, seems to raise

questions about the tax policy purpose of the requirement. There is no reason, for example, why a change in mortality charge guarantees to reflect a change in the insured’s rating or smoking status should affect a contract’s issue date, regardless of whether the policyholder had a contractual right to insist upon such a change. It is hoped that the IRS will reconsider the need for the “pursuant to the terms of the contract” requirement in more permanent future guidance that more readily accommodates changes in the prevailing mortality tables.

As noted, however, Notice 2016-63 makes two significant and helpful modifications relative to the material change rules of Notice 2006-95. The first helpful modification is that the notice provides that if the only change to an existing contract is a reduction or deletion of benefits provided under the contract, this change will not affect the contract’s issue date that applies for purposes of the notice’s safe harbors.¹² Thus, for example, if a life insurance contract does not provide any contractual right to reduce or decrease benefits (which, for example, is common with respect to the face amount of death benefit under ordinary whole life insurance contracts), and the insurer now decides to permit such reductions or decreases, such a change will not result in new issue treatment of the contract for purposes of the notice.

The second helpful modification is provided in the examples which illustrate the operation of section 5.02 of Notice 2016-63. In particular, the notice now provides that the “changes, modifications, or exercises of contractual provisions referred to in section 5.02 of this notice include ... reinstatement of a policy within 90 days after its lapse or *reinstatement of a policy as required under applicable state or foreign law*” (emphasis added).¹³ This emphasized language was not included in Notice 2006-95 and is helpful in that it removes a possible implication that exercises of contractual rights as required by applicable law to reinstate benefits beyond the 90-day period referenced in the prior notice could result in new issue treatment. Of course, as with the prior notice, since the operative rule is set forth in section 5.02 of Notice 2016-63, and section 5.03 of the notice merely offers examples, it appears that the exercise of a contractual right that satisfies the standards of section 5.02 of the notice would likely not result in new issue treatment, even if the transaction is not listed among the examples in section 5.03 of the notice.

CONCLUDING THOUGHTS

As noted above, Notice 2016-63 provides timely and helpful guidance that will assist taxpayers in transitioning to 2017 CSO. This is especially the case since it has been and remains important that the IRS provide safe harbor protection for standard-risk life insurance contracts in advance of the effective date for use of a new prevailing mortality table. The notice also provides helpful clarifications regarding the effect of benefit reductions and reinstatements for purposes of the notice’s material change rule. We continue to encourage the IRS to reconsider the material

change rule fundamentally since we think it serves little or no tax policy purpose and creates substantial administrative burdens, but given the time constraints involved, Notice 2016-63 offers much-appreciated interim assistance as more permanent guidance is considered. ■

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

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

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

Brian G. King is an executive director at Ernst & Young LLP and may be reached at brian.king3@ey.com.

ENDNOTES

- 1 2016-45 I.R.B. 683.
- 2 1988-2 C.B. 540.
- 3 2006-2 C.B. 848.
- 4 Notice 2016-63 § 8.
- 5 *TAXING TIMES*, vol. 12, no. 3 (Oct. 2016).
- 6 Section 7702(c)(3)(B)(i) (pertaining to the guideline single premium). See also section 7702(b)(2)(B) (incorporating this rule for purposes of the net single premium under the cash value accumulation test); section 7702(c)(4) (incorporating this rule for purposes of the guideline level premium); and section 7702A(c)(1)(B) (incorporating this rule for purposes of the 7-pay premium).
- 7 An alternative mortality charge rule, colloquially referred to as the “TAMRA interim rule,” generally allows for reflection of 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). See section 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, PUB. L. NO. 100-647.
- 8 Notice 2016-63 § 4.04.
- 9 Notice 2016-63 § 5.01.
- 10 *Id.*
- 11 Notice 2016-63 § 5.02.
- 12 *Id.* This effectively reverses the holding in *PLR 201230009* (Jan. 30, 2012).
- 13 Notice 2016-63 § 5.03.