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Prevailing Standard Mortality and Morbidity Tables May Be Adjustable for Tax Reserves

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Life insurance companies sometimes find that standard mortality and morbidity tables do not provide adequately for their statutory reserve liabilities for a variety of products. As a result, adjustments to statutory reserves are being made to standard mortality and morbidity tables frequently based, at least to some degree, on company or industry experience. Recently, this has been the case particularly for disability income and group annuity contracts. The tax question inevitably arises: can the company-specific adjusted statutory assumption for mortality or morbidity be used for tax reserves? The answer is—it depends on whether the prevailing standard table can be "adjusted as appropriate" under I.R.C. § 807(d)(2)(C).

Let's review the basic rules. I.R.C. § 807(d)(1) generally provides that the life insurance reserve for any contract is the greater of the net surrender value of the contract or the federally-prescribed reserve (FPR). The FPR is determined by using (i) the tax reserve method applicable to the contract, (ii) the greater of the applicable federal interest rate or the prevailing state assumed interest rate, and (iii) the prevailing commissioners' standard tables for mortality and morbidity. The tax reserve is then capped by the statutory reserves with respect to the contract set forth in the annual statement.

I.R.C. § 807(d)(5)(A) provides that the prevailing commissioners' standard tables means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners (NAIC) that are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states. There is an important exception to this general rule. In addition to providing that the tax reserve is based upon the prevailing standard mortality table, I.R.C. § 807(d)(2)(C) provides that the prevailing table can be "adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account."

The prevailing mortality table required to be used for tax reserves is a table that reflects "standard" mortality for the benefits to which the table relates. An adjustment to the table is appropriate under I.R.C. § 807(d)(2)(C), and may even be required, when an evaluation of insureds indicates that the mortality risks are not standard in relationship to the table. This can occur in life insurance when a contract is sold without underwriting (guaranteed issue) or when the insured lives are unhealthy or likely to be. In these circumstances, an extra premium generally is charged for the nonstandard risk and a reserve adjustment is made. The same is true for annuities if the annuitants are too healthy compared to standard lives. When an objective characteristic of the annuitants, or underwriting of the risks, reflects a likely deviation from the standard mortality under the applicable table which results in increased longevity risk, an extra premium is charged and extra reserves are established. Thus, for both life insurance and annuities, an adjustment to the standard table may be needed when risks are not reflected in the prevailing table for standard mortality. This is most likely to occur when the objective nature of the insured lives or underwriting indicates that the risks are nonstandard and, typically, an extra premium is charged for the coverage.

The legislative history elaborates on when an adjustment to the prevailing table may be appropriate:

> The Federally prescribed reserve requires the use of the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks, such as substandard risks, incurred under the contract which are not otherwise taken into account. If, for example, the commissioners' standard tables differentiate between smokers and nonsmokers, reserves relating to insureds that are otherwise standard risks except for known smoking habits must be computed using the commissioners' standard table for smokers without any adjustment to reflect substandardness due to smoking. This is appropriate because the factor of smoking is already taken into account, and any excess mortality due to such factor is implicit in the use of the smokers' table. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because

> of poor health or medical condition. An appropriate multiple should reflect the greater mortality expected, for example, from a person with a known heart or diabetic condition, in excess of the mortality of the group of standard insureds that is implicit in the prevailing commissioners' standard table. Also, adjustments to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks); or because the insureds reside in a foreign country known to be experiencing civil strife.[1]

This legislative history suggests that it is not sufficient to merely show that a company's particular group of insureds may have mortality or morbidity rates that *differ* from the prevailing table. Rather, in order to adjust the prevailing standard mortality or morbidity table, the company must demonstrate that its risks *were not reflected or implicit* in the prevailing table. Guidance from the IRS confirms that this is its interpretation of I.R.C. § 807(d)(2)(C).

In TAM 9251005,[2] an actuary determined that the company's disability income policies contained a definition of disability and provided benefits that were not reflected in the morbidity factors of the prevailing standard morbidity table. As a result, the company made adjustments to the prevailing table to reflect the risks not covered. The IRS agreed that this adjustment was permissible for tax reserves. In fact, the IRS went further and suggested that an adjustment to the prevailing table may be appropriate for tax reserves in these circumstances even though a similar adjustment had not been made for statutory reserves.

By contrast, in TAM 200416009,[3] actuaries determined that their company's mortality experience under annuity contracts was less than that reflected in the prevailing table. As a consequence, the company adjusted the mortality table for its own experience by decreasing the mortality assumptions. In ruling against the taxpayer, the IRS set forth what it considered to be the initial hurdle to overcome to qualify for an adjustment to the prevailing table:

> As reflected in the examples provided [in the legislative history], in order to justify a modification of the tables, the Taxpayer must be able to show not merely that its experience differs, even significantly differs, from the experience assumed in the tables. Rather, the Taxpayer must also show that its population reflected a risk 'not taken into account' . . . In adopting the language 'adjusted as appropriate to reflect the risks . . . not otherwise taken into account', Congress meant to allow reserves for

> additional risks such as smoking that are in excess of the core contingencies. The Taxpayer did not perform any study or analysis that would identify a characteristic of its annuitant population associated with greater risk or a characteristic not identified with the characteristics of the mortality table pool in general. The only analysis performed by the Taxpayer was an analysis of mortality . . . Accordingly, Taxpayer may not adjust the applicable mortality table in connection with its immediate and supplementary annuity contracts for risks incurred that were taken into account in computing the applicable prevailing commissioners' standard mortality table and, therefore, were not risks 'incurred under the contract which are not otherwise taken into account.'

TAM 9251005 and TAM 200416009, taken together, suggest that the IRS views the "adjusted as appropriate" analysis as a two-step process. The first step is to determine whether an adjustment to the standard table is required for nonstandard risks. For this step, it is necessary to examine the underlying data used in developing the prevailing table and then determine if the company's particular risks were reflected in that underlying population. Only after this step is satisfied can the company proceed to the second step and determine the "appropriate" level of the adjustment for the nonstandard risks.

> It is not sufficient to merely show that a company's particular group of insureds may have mortality or morbidity rates that differ from the prevailing table. Rather, … , the company must demonstrate that its risks were not reflected or implicit in the prevailing table.

In the first step, a comparison of the standard risks considered in the prevailing table with the risks covered in the company's contracts is required. There are two types of risks for which adjustments to the prevailing table are appropriate as reflected in these two TAMs. One type of risk is reflected in TAM 9251005, where an adjustment to the table was necessary because the disability contract provided a benefit that was not reflected in the underlying table, and because the additional benefit was likely to result in a different morbidity risk. In other words, the prevailing table did not reflect the same benefits, and, therefore, different morbidity experience could be anticipated. This is the type of situation that frequently gives rise to a table adjustment for disability income policies.

A second type of risk for which an adjustment is required arises for substandard or nonstandard risks. This is a situation where the contract benefits are the same as assumed in the table, but the demographics of the insured lives reflects a different level of risk. This is the more likely situation for individual life insurance contracts insuring substandard risks. More recently, this situation is arising for group annuity contracts where the facts are distinguishable from the annuity contracts in TAM 200416009. In that TAM, the company issued annuity contracts to standard risks and sought to adjust the table because its own experience indicated greater longevity than the standard table. The adjustment was denied for tax purposes because the table reflected the same standard risks as in the company's contracts. To make an adjustment as appropriate, it must be established that the contract covers nonstandard longevity risks that annuitants could live longer than those reflected in the standard table.

Once it is determined that an adjustment to the standard table is necessary, the next step is to determine the amount of the adjustment that is appropriate. This can be determined by using the company's own experience to the extent it is credible, industry-wide experience or a combination of both. It is important to understand that company and industry-wide experience, standing alone, cannot be used to support an adjustment to the prevailing table for standard risks. But, experience can, and probably should, be used to determine the "appropriate" adjustment. What is ultimately determined to be an appropriate adjustment requires actuarial judgment that is not likely to be challenged successfully by the IRS if it is supported by contemporaneous actuarial analysis, and especially if (despite the implied leniency in TAM 9251005) the adjusted mortality or morbidity assumptions also are used for statutory reserves. ■

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ENDNOTES

1 Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 603 (1984) (footnote omitted). See also H.R. Rep. No. 98-432, pt. 2, at 1416 (1984); S. Prt. No. 98-169, vol. I, at 542 (1984).

2 (Sept 9, 1992)

3 (Apr. 16, 2004)