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NEW RULINGS CAN BE TAXING

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The new 2001 CSO Mortality Table affects company taxation of life insurance policies, and one recent and another proposed revenue ruling will affect policyholder taxation of life insurance policies. This article discusses some of the new changes.

Most insurance companies have already tested the effect that the 2001 CSO Mortality Table has on the products the company is currently marketing. Just as the 2001 CSO Mortality Table will generally reduce statutory reserves, the table will also generally reduce tax reserves.

In most situations we can expect tax reserves based on the 2001 CSO Mortality Table to be less than those based on the 1980 CSO Mortality Table, but it appears as if this change may not take place immediately. The Internal Revenue Code (IRC) provides for a three-year transition period before insurance companies are required to change to the new mortality table for purposes of computing tax reserves for new policies issued. This transition period is from 2005 through 2007.

Many companies are interpreting the transition period as a time during which the insurance company may choose which mortality table to use when determining tax reserves, and they are choosing the table that produces the highest reserves. A higher tax reserve provides a larger tax deduction in the early policy years and makes the policy more profitable on an IRR or present value basis. When 2008 rolls around, all policies issued will have to use the 2001 CSO Mortality Table for tax reserves.

From a marketing standpoint, the 2001 CSO Table will reduce the amount of premium that can be paid into a universal life policy, because the lower mortality rates will decrease the guideline premiums. The table below compares guideline single premiums for a male, nonsmoker based on 2001 CSO ultimate rates and 1980 CSO rates.

GUARANTEED COIS	ISSUE AGE 35	ISSUE AGE 55
1980 CSO	$12,974	$32,217
2001 CSO	$10,714	$27,750

The Internal Revenue Service published Revenue Ruling 2005-6 on Feb. 7, 2005. This revenue ruling affects policyowner taxation of an insurance policy. This is different from the discussion concerning the 2001 CSO Mortality Table, which affected the federal income taxes for the insurance company. Revenue Ruling 2005-6 defines the way in which certain qualified additional benefits (QABs) affect the guideline premiums defined in Section 7702 and Modified Endowment Contract (MEC) premiums defined in Section 7702A of the IRC.

This revenue ruling says that QABs must follow the expense rule as defined in Section 7702 when determining the guideline and MEC premiums for an insurance policy. Essentially, this means that the current, rather than the guaranteed, charges in the contract for the QAB must be used in determining the guideline and MEC premiums.

Riders on universal life policies such as spouse riders are often affected by this ruling. The guideline premium was often determined for the spouse rider using guaranteed mortality charges for the rider, such as the 1980 CSO Mortality Table, rather than the current cost of insurance charges. Using the current charges

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rather than the guaranteed charges reduces the guideline premiums. Since the revenue ruling applies retroactively as well as prospectively, this may result in situations where contracts were ove funded in the past due to the incorrect higher guideline premium. Based on conversations with insurance companies that have QABs on universal life policies, as many as 80 percent of the companies were using the guaranteed cost of insurance rates rather than the current rates in determining the guideline premiums.

The revenue ruling provides ways of remedying the situation should the insurance company have policies in violation of Section 7702 due to using the incorrect cost of insurance rates for QABs. The IRS will allow the company to pay a penalty based on the number of contracts on the compliance system. The penalty ranges from $1,500 for 20 or fewer contracts up to $50,000 for 10,000 or more contracts. The company does not have to change the policies that are out of compliance. Instead, the policies will have to follow the revised guideline premium going forward. This remedy could create system challenges for determining how much premium can be put into these polices when creating in-force illustrations.

A second, proposed revenue ruling was published this year that addresses the attained age that must be assumed when determining Section 7702 death benefit factors for life insurance policies. As an example, the revenue ruling says that the true age of the insured must be used for the Section 7702 factors. This may seem like an obvious ruling, but it may affect policies in force that were "rated up" where the policy values assumed an age higher than the true age of the insured. Some products were designed to rate up the age as a substitute for table rating based on the true age of the insured.

Policies that are "rated up" will have to use the true age for Section 7702 factors. For example, a 70-year-old insured that was rated up to age 75 will have to use corridor factors based on the true issue age of 70 rather than the assumed issue age 75. This may affect illustration systems and administration systems for some companies.

Similarly, last survivor and first-to-die policies were affected by this proposed revenue ruling. Last survivor policies cannot use an age older than the youngest age of the insureds when determining Section 7702 death benefit factors. Likewise, first-to-die policies cannot use an age older than the oldest of the insureds. This may affect the illustration and administration of these types of policies.

Tax rulings such as these are often under the radar screen of professionals working in the marketing and distribution areas of insurance companies. However, it is necessary to be aware of these rulings in order to maintain compliance with Sections 7702 and 7702A of the IRC.

Section to Co-Sponsor Product Development Actuary Symposium

The Marketing and Distribution Section will once again co-sponsor the Product Development Actuary Symposium with the Product Development, Actuary of the Future and Reinsurance Sections. The event is slated for June 26-27, 2006 at a location still to be determined. Please contact Rob Stone, MaD Section representative on the planning committee, at Rob.Stone@milliman.com for additional details as they become available.

Section to Co-Sponsor 2006 Life Conference

The Marketing and Distribution Section has volunteered to help plan the 2006 Life Conference, a meeting jointly sponsored by LIMRA, LOMA, the SOA and the ACLI. The event takes place April 3-5, 2006, at the Hilton in the Walt Disney World Resort. For additional conference information, please visit any of the sponsoring organizations' Web sites.