Tax Implications of Proposals for Structuring Commissioners' Mortality Tables to include the Extra Mortality Risk of Business not Subject to Full Underwriting

The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Tax Work Group
Life Practice Council
American Academy of Actuaries

Barbara R. Gold, FSA, MAAA, Chair

Timothy Branch, EA, FSA, M.A.A.A
Steve Chamberlin, FSA, MAAA
Armand de Palo, FSA, MAAA
Alan Emmer, FSA, MAAA
Barbara Lautzenheiser, FCA, FSA, MAAA
Brian Lessing, FSA, MAAA
Kory Olsen, CERA, FSA, MAAA
Art Panighetti, FSA, MAAA
Brian Prast, FSA, MAAA
James Reiskytl, FSA, MAAA
Edward Robbins, FSA, MAAA
Bruce Schobel, FCA, FSA, MAAA
Donald Walker, ASA, MAAA

This document does not constitute tax advice and any tax information contained in this document (including any attachments, enclosures, or other accompanying materials) is not intended or written to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties. Any party seeking tax advice should consult with an independent tax advisor/expert.

Purpose of Paper

The purpose of this paper is to discuss from a tax perspective the pros, cons and issues of designing new commissioners' standard mortality tables to include the extra mortality risk of less than fully underwritten business. This paper reviews four options for structuring the next commissioners' standard mortality tables. As additional options are developed, The Tax Work Group will provide analysis of them as appropriate.

We have made two assumptions for the purpose of completing the analysis in this paper. First, we have assumed the tables under discussion will be used for defining both the minimum statutory reserves and minimum nonforfeiture values for a given policy. If the additional mortality tables are instead only used for statutory reserves, the Tax Work Group will need to revise the analysis with respect to the product tax implications - Sections 7702 and 7702A of the Internal Revenue Code (IRC), which define life insurance contract and modified endowment contract, respectively. Second, we have assumed in this paper that the current structure of VM-20 (as currently exposed by the National Association of Insurance Commissioners) will be retained. In other words, Net Premium Reserves will be based on these tables, and the Deterministic Gross Premium and Stochastic Reserves will be based on these tables or experience-adjusted versions of these tables.

Based on the Internal Revenue Service (IRS) guidance issued on VACARVM, a reasonable assumption can be made that under VM-20 the Net Premium Reserve will likely be the basis of the federally prescribed tax reserve and that the Deterministic Gross Premium and Stochastic Reserves will not be tax deductible reserves. If that is the case, it is important to note that in some situations, the new mortality table(s) could impact tax reserves without impacting statutory reserves. Specifically, if we assume that the option chosen for the design of the commissioners' standard mortality tables does not affect the level of the Deterministic Gross Premium and Stochastic Reserves (i.e., these reserves would be based on company experience), the statutory reserve would not change. However, the tax deductible reserve would be affected by any change to the Net Premium Reserve.

Background – Mortality Tables

Historically, the Commissioners' Standard Ordinary (*i.e.*, CSO) mortality tables were based only on the industry's mortality experience on individual standard issues of fully underwritten business. A loading formula was added to the graduated mortality experience table (*i.e.*, Valuation Basic Table) to recognize that mortality risk varies between insurers and over time and to make the CSO mortality table adequate for statutory valuation purposes. The CSO mortality table was not designed to cover reserving for substandard business and business that was not fully underwritten. Life companies were generally expected to hold extra statutory reserves for these types of business.

It should be noted that both the absolute level of mortality and the curvature of the mortality table affect the level of net premium reserves. Higher mortality results in higher reserves for paid-up coverage. However, this is not always true during the premium paying period. How a change in mortality rates affects net premium reserves during the premium paying period also depends on the curvature of the mortality table.

For Gross Premium Reserves, given the same gross premium, higher mortality, regardless of curvature, will produce a higher Gross Premium Reserve.

Moving from the 1980 CSO tables to the 2001 CSO tables produced lower net premium reserves and lower nonforfeiture values because the curvature of these two mortality tables is very similar and the 2001 CSO table has lower overall mortality.

Also, the relationship between reserves on the select and ultimate table as compared to reserves on the ultimate table must be considered. After the select period, while premiums are still being paid, reserves on the ultimate table are generally lower than reserves on the select and ultimate table.

Background – Tax Reserves

In general, tax reserves for federal income tax purposes must be computed under Section 807(d)(2) of the IRC using "the prevailing commissioners' standard tables for mortality and morbidity." This phrase is defined in Section 807(d)(5) of the IRC to mean "the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for the type of contract under the insurance laws of at least 26 States when the contract was issued." A special rule in Section 807(d)(5)(E) of the IRC provides that where, with respect to any category of risks, there are two or more tables or options under a table, the table or option which generally yields the lowest tax reserves must be used. This rule has been implemented by the IRS by specifying that the table or option which generally yields the lowest tax reserves on an industry-wide basis is required to be used. If several options are equivalent, then either option is acceptable. Historically, the Aggregate Ultimate Mortality Table has been shown to produce the lowest tax reserves. Splits such as smoker / nonsmoker have been shown to be equivalent in the aggregate to the Aggregate Ultimate Mortality Table, based on the distribution of those risk classes in the experience underlying the construction of the table.

If a company wishes to establish and deduct additional tax reserves for expected extra mortality not reflected in the standard table as defined in the IRC, there are two methods which may be used. The first method may be used if the risk is considered a "qualified substandard risk." If the substandard risk meets all the necessary criteria as defined in Section 807(e)(5) of the IRC to be considered a qualified substandard risk, the reserve will be calculated separately from any other reserve on the contract. This additional substandard reserve is limited to the sum of the separately identified premiums charged for the risk plus interest and minus mortality charges. Furthermore, the amount of insurance in force under contracts which have reserves for qualified substandard risks cannot exceed 10% of the insurance in force (other than term insurance) in the company. For most life companies that primarily sell fully underwritten business, this limitation is not normally a problem. In addition, the reserve for a qualified substandard risk is not included in the three-prong comparison.[1] This is the method generally used for traditional business.

The second method used to calculate additional tax reserves for expected extra mortality is to rely on Section 807(d)(2)(C) of the IRC which provides for an adjustment to the prevailing commissioners' mortality tables as appropriate to reflect the risks incurred under the contract which are not otherwise taken into account. Additional tax reserves calculated using this method must be included in the three-prong comparison.

[1]Three-prong comparison: Tax reserve = the greater of the Federally Prescribed Reserve (as defined in the Internal Revenue Code) and the Net Surrender Value, but no more than the Annual Statement Reserve

Regardless of which method is used, as always, tax deductible reserves may not exceed the statutory reserves held for the contract.

It should be possible to define multiple federally prevailing commissioners' standard tables as long as each table applies exclusively to a defined set of policy forms and no choice is possible. If a choice of table is permitted, the federally prevailing mortality table would be the one that produces the lowest tax reserves on an industry-wide basis for the policy forms for which it would apply.

This means that a critical issue from a tax perspective is to define "standard" appropriately. Simplified Issue, Pre-Need and Guaranteed Issue are different than Ordinary business in this regard, since Simplified Issue, Pre-Need and Guaranteed Issue business are, in most cases, either issued or declined, and do not, in general, have a substandard classification. For these types of business, the definition of "standard" could vary by the degree of underwriting rigor that applies for that business.

Thus, if multiple tables are produced, the labels would need to include "standard" for a "type of contract." For example:

CSO: used only for contract types that are subject to full individual underwriting standards.

CSSI: used only for contract types that are only subject to reduced or limited underwriting standards.

CSPN: used only for contract types that are exclusively used for Pre-Need life business.

CSGI: used only for contract types that are exclusively used for Guaranteed Issue life business.

If this structure were to be used, consideration should also be given to using the CSGI classification for Group Term Life business to modernize that table.

Background – Product Tax

A life insurance contract must qualify as life insurance under Section 7702 of the IRC in order to receive favorable federal income tax treatment. Also, Section 7702A places additional limits on the funding of life insurance contracts in order for the contract to have favorable distribution rules. Currently, the calculation of the limits in these two IRC sections is based in part on an NAIC prescribed mortality table that meets federal tax requirements. Thus, it is critical in designing any new commissioners' standard mortality tables that will be used for both statutory valuation purposes and minimum nonforfeiture values that such tables be designed and applied in such a way as to not create issues under these two IRC sections.

Life insurance contracts that fail to comply with the requirements of IRC Section 7702 are generally not viable for sale, since they would be currently taxed on the inside buildup within the contract.

Life insurance contracts that fail to comply with the requirements of IRC Section 7702A are Modified Endowment Contracts (MECs). Under a MEC, policy loans are treated as distributions and all distributions are taxed on any gain first. Also, there may be a penalty tax.

One of the factors to be taken into account in making the required computations under Sections 7702 and 7702A is "reasonable" mortality charges. These are defined as "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." It is important to note that this rule permits the Treasury Department, at its discretion, to issue regulations that define "reasonable" mortality charges which diverge from the rates specified in any prevailing commissioners' standard tables.

The "prevailing commissioners' standard tables" (as defined in Section 807(d)(5)) refer to the tables used for tax reserving and are described above.

Since the Aggregate Ultimate Mortality Table has been shown to produce the lowest tax reserves, it is the ultimate table that is used for product tax testing. If this were not the case, then product tax testing would have to be done using the Select/Ultimate tables. This would entail considerable additional systems work. Splits such as smoker / nonsmoker have been shown to be equivalent in the aggregate to the Aggregate Ultimate Mortality Table.

Current laws provide a linkage which has minimized product tax issues. For a particular policy form, the same mortality table that is permitted to be used by the states for valuation and that produces the lowest tax reserves has been permitted by the states to be used for minimum nonforfeiture calculations. As a result, that mortality table has become the prevailing commissioners' standard table for tax reserving and has been accepted by the Treasury Department as the basis for reasonable mortality charges (subject to different effective dates).

Thus, in order to assure that life insurance contracts can comply with Sections 7702 and 7702A, it is critical in the development of new commissioners' standard mortality tables that:

1. Testing be performed on an industry-wide basis to define which table produces the lowest aggregate tax reserves for the industry for the policy forms for which it is allowed to be used. This table would then become the prevailing commissioners' standard table.
2. The mortality table used in the nonforfeiture law for that policy form not exceed the mortality in the table used for tax reserves, that is, the prevailing commissioners' standard table.

Issues

Recently, the Life Actuarial Task Force (LATF) of the NAIC has been considering the need for additional valuation mortality tables for less than fully underwritten business, such as Simplified Issue, Pre-Need and Guaranteed Issue business. This business has higher expected mortality and far less expected select experience than the individually underwritten business underlying the traditional CSO mortality table. Our understanding is that data is being gathered by the Society of Actuaries (SOA) on mortality experience for ordinary standard risks and for Simplified Issue, Pre-Need, and Guaranteed Issue life business.

The applicable federal income tax rules outlined above suggest several important considerations that should be taken into account in developing new mortality tables in order to avoid uncertainty in computing tax reserves, determining product tax compliance, and to not create unnecessary

differences in interpretation. To fit within the tax law framework, a "standard table" should be prescribed by the NAIC for a "type of contract." This means two things: (1) the NAIC needs to classify contracts by an identifiable "type" when prescribing a new table and (2) each type of contract should have a single "standard" table to the extent possible. Furthermore, there needs to be clarity as to the risks that are being reflected in a "standard table" so that it can be determined whether and how to adjust the table for tax purposes for risks that are otherwise not taken into account in the table.

If the risk is covered in a standard table, and the table contains two or more options, then the option yielding the smallest tax reserve must be used. Therefore, in order to avoid confusion and ambiguity, there should not be "options" under a table where each option is really dealing with different risks.[2] There should be different tables for different types of contracts where there are distinct risks, not options under the same table where the risks are really different.

Thus, if the classifications of Simplified Issue, Pre-Need and Guaranteed Issue become part of the commissioners' standard mortality tables, it is essential that clear definitions are provided for which policies ("types of contracts") will be classified as Simplified Issue, Pre-Need and Guaranteed Issue. It is important to note that three general types of Guaranteed Issue (GI) contracts are currently available – mass marketed GI with low early death benefits, GI for the individual members (versus the executives) of an organization (*e.g.*, Pension Trust GI), and GI for executives. While these share the lack of a select period, executive GI has significantly better expected mortality than the other forms. If the definitions are not clear, IRS/Treasury might determine that more than one mortality table could be appropriate for a particular contract and require that reserves be calculated using the mortality table that generally produces the lowest tax reserves. The lack of a clear definition for this business could also have product tax implications. Specifically, as mentioned above, Section 7702 of the IRC indicates that, absent Treasury regulations to the contrary, the mortality tables prescribed in Section 807(d)(5) of the IRC for the calculation of tax reserves constitute the maximum mortality charges that can be used in the Section 7702 and 7702A computational limits.

As a stop-gap measure, even though the 2001 CSO Mortality Table was initially adopted in 2004 for all individual life business, the NAIC agreed in 2008 that for Pre-Need life business only, the 1980 CSO Mortality Table would continue to be the minimum requirement for both reserves and nonforfeiture values. This was done since many Pre-Need life companies were concerned that the 2001 CSO Mortality Table would be inadequate for their business. Furthermore, if they calculated their additional tax reserves for substandard business using the "qualified substandard risk" method described above, these reserves would likely not be fully tax deductible because of the 10% aggregate limitation on substandard reserves.

As a result, the life industry currently has multiple prevailing commissioners' standard mortality tables, the 1980 CSO Mortality Table that is only used for all Pre-Need life business, the 2001 CSO mortality Table for all other ordinary individual life business and a table for Industrial Business.

With respect to group life insurance, note that Group Permanent insurance falls within the scope of this paper and should be assessed under Options I through IV below. The "Valuation of Life

[2] In the event that "options" do exist within a mortality table (e.g., smoker/nonsmoker splits of an aggregate mortality table), it is very important for tax purposes that the mortality rates from the resulting disaggregation of risk classes are approximately equivalent to the mortality rates of the aggregate table, based on the distribution of those risk classes in the experience underlying the construction of the table.

Insurance Policies Model Regulation" [commonly referred to as "Reg. XXX"][3], which was adopted in 2000, includes group life insurance in its scope other than group life insurance whose premium scale guarantees do not exceed 1 year. Thus, Group Permanent life insurance is subject to the same valuation standards as individual life and new issues of Group Permanent life must reflect the 2001 CSO Table. Group Term life and Group Permanent life with shorter guarantees are outside the scope of this paper.

Options

Following are tax issues associated with four options currently being considered for the design of commissioners' standard tables for business not subject to full underwriting.

Option I: Create a single commissioners' standard mortality table that also covers the risk of less than fully underwritten business (contract types). In addition to the Super Preferred Nonsmoker, Preferred Nonsmoker, Residual Standard Nonsmoker, Preferred Smoker and Residual Standard Smoker classifications, it would also have Simplified Issue, Pre-Need and Guaranteed Issue splits.[4] A variation of this option would have Simplified Issue, Pre-Need and Guaranteed Issue aggregated in the Residual split.

Option II: In addition to the current Commissioners' Standard Ordinary mortality table, create three new commissioners' standard mortality tables for Simplified Issue, Pre-Need, and Guaranteed Issue contracts.

Option III: In addition to the current Commissioners' Standard Ordinary mortality table, create one new commissioners' standard mortality table combining the Simplified Issue, Pre-Need and Guaranteed Issue contracts.

Option IV: Retain the current CSO structure of developing the table based on only fully underwritten contracts. Use this table for all Net Premium Reserves and nonforfeiture values. Develop additional SOA mortality experience tables for less underwritten contracts for the calculation of the excess Deterministic Gross Premium Reserves and excess Stochastic Reserves under Life PBR.

Pros, Cons and Issues of Option I – Creation of a single commissioners' standard mortality table that also covers the risk of less than fully underwritten business.

Pros:

– Consistent with current framework.

– A single commissioners' standard mortality table would eliminate any concerns with multiple federally prevailing mortality tables

.

Cons:

[3] "2011 NAIC Accounting Practices and Procedures Manual", Appendix A-830.

[4] "NAIC Model Regulation Permitting the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities"

– If business with limited underwriting is combined with underwritten business, the Overall Aggregate Ultimate mortality table, which is very important for federal tax and nonforfeiture purposes, would be increased.

– If there is a single mortality table, companies will have a choice as to how to use the various options within the mortality table. Unless the less–than-fully-underwritten business is restricted to using only certain parts of the Overall table, a problem will exist.

Issues:

– Combining Ordinary life fully underwritten business with business exhibiting much different mortality experience characteristics will create some technical issues with respect to producing a reasonable aggregate ultimate mortality table. There are additional issues because minimum nonforfeiture values and product tax testing are currently based on the Aggregate Ultimate CSO mortality table.

– Such a table would likely have different curvature than the current table. The impact on the level of reserves and funding limits must be carefully reviewed.

– The possibility of higher nonforfeiture values and higher funding limits could raise issues with the industry and Treasury/IRS.

– The possibility of higher reserves could raise issues with the industry (because of possible surplus strain) and Treasury/IRS.

Pros, Cons and Issues of Option II – Creation of three additional commissioners' standard mortality tables that cover the risk of less-than-fully-underwritten business.

Pros:

- Having separate mortality tables for Ordinary, Simplified Issue, Pre-Need and Guaranteed Issue business would eliminate problems as to how to combine the experience to produce a proper Aggregate Ultimate mortality table that can still be used for tax purposes.

Cons:

- Having several commissioners' standard mortality tables could raise concerns with the IRS and Treasury as to which mortality tables are used for tax proposes. This may not be an issue for tax reserves under IRC Section 807(d), since those are based on the NAIC minimum standard. However, this could be a significant concern for product tax issues under IRC Sections 7702 & 7702A. While the mortality tables prescribed in IRC Section 807(d) currently constitute the maximum mortality charges that can be used in the IRC Section 7702 & 7702A computational limits, Treasury has the discretion to prescribe other mortality tables. Resolution of this issue may depend on which tables are required by the NAIC for defining the minimum nonforfeiture values.

Issues:

- For IRC Sections 807(d), 7702 and 7702A purposes, the Aggregate Ultimate mortality table and any of its equivalent splits (*e.g.*, smoker/nonsmoker) are used for tax purposes. If multiple commissioners' standard mortality tables exist, the Standard Nonforfeiture Law would need to be changed to refer to these additional commissioners' standard mortality tables and not just CSO mortality tables. It would also have to contain very clear definitions as to which policy forms use which tables.

- If three additional commissioners' standard mortality tables were developed for less underwritten business, it is very likely these additional mortality tables will have far less curvature than the Commissioners' Standard Ordinary mortality table for underwritten business. This will mean for Net Premium Reserves during the premium paying period, the less underwritten business is likely to have both lower nonforfeiture values and lower Net Premium Reserves. However, a higher maximum mortality charge can be used in pricing.

Pros, Cons and Issues of Option III – Creation of one additional commissioners' standard mortality table that covers the risk of less than fully underwritten business.

Pros:

- Having a separate mortality table for Ordinary, Simplified Issue, Pre-Need and Guaranteed Issue business would eliminate problems as to how to combine the experience to produce a proper aggregate ultimate mortality table that can still be used for tax purposes.

- Having one table containing all three types of business would involve less work than individual tables for each type of business.

- A single table would reflect a wide range of underlying company experience.

Cons:

- Having two commissioners' standard mortality tables could raise concerns with the IRS and Treasury as to which mortality tables are used for tax purposes. This may not be an issue for tax reserves under IRC Section 807(d), since those are based on the NAIC minimum standard. However, this could be a significant concern for product tax issues under IRC Sections 7702 & 7702A. While the mortality tables prescribed in IRC Section 807(d) currently constitute the maximum mortality charges that can be used in the IRC Section 7702 & 7702A computational limits, Treasury has the discretion to prescribe other mortality tables. Resolution of this issue may depend on which tables are required by the NAIC for defining the minimum nonforfeiture values.

- A mortality table combining three types of business, each of which potentially having substantially different experience, may not be appropriate for any of the businesses individually.

Issues:

- For IRC Sections 807(d), 7702 and 7702A purposes, the aggregate ultimate mortality table and any of its equivalent splits (*e.g.*, smoker/nonsmoker) are used for tax purposes. If multiple commissioners' standard mortality tables exist, the Standard Nonforfeiture Law would need to be changed to refer to these additional Commissioners' Standard mortality tables and not just CSO

mortality tables. It would also have to contain very clear definitions as to which policy forms use which tables.

- If one additional commissioners' standard mortality table was developed for less underwritten business, it is very likely this additional mortality table will have far less curvature than the Commissioners' Standard Ordinary mortality table for underwritten business. This will mean during the premium paying period, the less underwritten business is likely to have both lower nonforfeiture values and lower Net Premium Reserves. However, a higher maximum mortality charge can be used in pricing.

<u>Pros, Cons and Issues of Option IV</u> - Retain the current CSO structure of developing the table based on only fully underwritten business. Use this table for all Net Premium Reserves and nonforfeiture values. Develop additional SOA experience tables for less underwritten business for the calculation of the excess Deterministic Gross Premium Reserves and excess Stochastic Reserves under Life PBR.

Pros:

- This would not give rise to additional tax related issues over those usually encountered when a new mortality table is developed.

- This assures the Net Premium Reserves on less underwritten business will be at least as large as for fully underwritten business. As discussed earlier, the level of reserves is dependent on both the level of the mortality and the curvature of the table.

Cons:

- None

Issues:

- This Option is only viable under current VM-20 structure.

<u>Conclusion</u>

Although Option IV would likely be the easiest of the options to implement form a tax perspective, it is very important to consider all the potential tax implications outlined above in designing a new Commissioners' mortality table (or tables) to cover the extra mortality risk of less than fully underwritten business. The design could have a significant impact on both company taxation – the deduction for tax reserves - and product taxation – Sections 7702 and 7702A of the IRC.

While the purpose of this paper is to examine the tax issues associated with designing a mortality table or tables to cover less than fully underwritten risks, the Tax Work Group recognizes that non-tax issues such as product pricing, nonforfeiture values, discrimination, and policy administration need to be considered in any final decision.