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AMERICAN ACADEMY *of* ACTUARIES

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October 9, 2009

CC:PA:LPD:PR (Notice 2009-47)  
Room 5203  
Internal Revenue Service  
PO Box 7604  
Ben Franklin Station  
Washington DC 20044

Dear Sir or Madam,

The American Academy of Actuaries'<sup>1</sup> Life Practice Council Tax Work Group (Work Group) appreciates the opportunity to comment to the Internal Revenue Service (IRS) on Notice 2009-47 (Notice) regarding "Application of Sections 7702 and 7702A to Life Insurance Contracts That Mature After Age 100." The Notice proposes safe harbor guidelines that affect the actuarial design and administration of life insurance contracts. We thank the IRS for inviting public comments on these issues. The Work Group would like to identify several actuarial issues and concerns with these proposals.

The Notice's treatment of these contracts as endowments<sup>2</sup> and therefore as taxable events seems unintended and undesirable, with little revenue to be raised by the government in aggregate and a potentially large tax burden on those individual policyholders affected.

As explained in this letter, the actuarial concept of an age after which there are no survivors (that is, an "omega" or the age immediately following an assumed mortality rate of 100%) is simply a practical assumption. There will be a few people who live beyond the selected omega point but there are so few that for most purposes they are immaterial for the calculations of premiums and contract values. The Society of Actuaries' report *2001 CSO Implementation Under IRC Sections 7702 and 7702A* recommended a practical solution for contracts continuing past age 100 and we recommend that it be adopted.

The Work Group respectfully requests your consideration of the following comments that address several actuarial issues related to the Notice. Our comments fall into three topic areas:

- Explaining the rationale and practical uses by actuaries of the end point of an actuarial mortality table (i.e., age omega) and the demonstration of inherent inconsistency of a fixed corridor with such an end point. Note also, as a numerical issue, that the pattern of

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<sup>1</sup> The American Academy of Actuaries is a 16,000-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.

<sup>2</sup> These contracts are neither endowments nor maturities unless it is by the terms of the contract. The deemed maturity age of 95 in IRC Section 7702 is only for calculation purposes and does not imply the contract has matured nor endowed.

the minimum corridor amount from age 91 to 99 (less than 105%) is inconsistent with the 105% amount from ages 100 and higher.

- Because of the inconsistency of a fixed corridor amount with the Standard Nonforfeiture Law (SNFL),<sup>3</sup> any cash value accumulation tested (CVAT) whole life policy that continues after age 100, and complies with SNFL requirements, will not be eligible for the proposed safe harbor. Conversely, to comply with the fixed corridor amount under the Notice will cause the policy to fall out of compliance with the SNFL.
- The IRS's perceived concern that section 7702 would allow for contracts to be issued with no amount at risk at issue.

### **The rationale and practical uses by actuaries of the end point of an actuarial mortality table (i.e., age omega) and the demonstration of inherent inconsistency of a fixed corridor with such an end point**

Cash values for traditional life insurance contracts are based on statutory formulas that have been promulgated by the NAIC. These formulas refer to mortality tables that have also been promulgated by the NAIC. All such tables have a defined maximum age or omega. The practical assumption made by actuaries is that everyone dies by the time that age is reached.

Early examples of statutory mortality tables for life insurance had omegas less than age 100. More recent mortality tables including the 1941 CSO, 1958 CSO, and 1980 CSO tables used omega equal to 100. However, as people live longer, there has been pressure to increase omega to accommodate longer life spans.<sup>4</sup> We have seen this with the promulgation of the 2001 CSO tables, which introduced an omega equal to 121. The assumption that everyone dies before they reach omega was never intended to exactly match reality. Rather, it is a computational convenience that allows the actuarial mathematics to be handled more easily and promotes consistency.

### **Because of the inconsistency of a fixed corridor amount with the SNFL, any cash value accumulation tested (CVAT) whole life policy that continues after age 100 and complies with the state requirements under the SNFL, will not be eligible for the proposed safe harbor**

The SNFL defines the minimum cash value at the end of a policy year as the actuarial present value of future benefits less the actuarial present value of future "adjusted premiums" (if any). In this context, the phrase "actuarial present value" means the future value, discounted back to the present.

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<sup>3</sup> This is a model statute specifying minimum cash values and other minimum nonforfeiture benefits. It was adopted by the National Association of Insurance Commissioners and has been enacted virtually identically in all 50 states.

<sup>4</sup> It is often observed that centenarians are the fastest growing age group in the USA, so there was considerable impetus to move the limiting age upward. At the same time, there are many longevity studies that suggest that, absent a scientific breakthrough, age 120 may well be the limiting age, so age 121 was chosen as the new omega. This is not meant to imply that everyone will die by age 120, but that living beyond age 120 is extremely unlikely based on current knowledge and experience.

The existence of omega has an effect on the statutory cash values associated with a traditional whole life policy. Since it is assumed that no one lives to omega, it follows that anyone alive at age ‘omega minus one’ is certain to receive a death benefit. The cash value at ‘omega minus one’ must equal the death benefit, discounted for one year’s interest, minus any premium that is due at the beginning of that year (such premium would not be discounted at all, since it is payable immediately). The cash value at the moment before omega must be the death benefit itself, whether or not the policy endows. Since the SNFL defines the floor for cash values, it is not possible, using any existing regulatory mortality table (all of which have omegas), to maintain any net amount at risk at omega and beyond. And, at ‘omega minus one’, it is probable that the cash values will be quite close to the death benefit at ‘omega minus one’. Therefore, since all of the current mortality tables use an omega, the minimum cash values required under the SNFL will eventually exceed the values allowed under the proposed safe harbor for all mortality tables.

Any CVAT whole life policy that continues after age 100 will not be eligible for the proposed safe harbor under the SNFL for all mortality tables currently applicable.

The Notice introduces a 5% corridor into the section 7702 calculation. A 5% corridor (or any corridor) can be shown to be inconsistent with any mortality table that implicitly assumes that everyone dies at a specific point in time (that is, omega). This inconsistency can be demonstrated by showing that for all traditional whole life policies using the Cash Value Accumulation Test (CVAT), at some point in the policies’ existence, the amount at risk is less than 5%. Any such requirement would appear to contradict the express rules of sections 7702 and 7702A. See the attached tables in Appendices A and B for demonstrations of various points at which this will occur.

For policies subject to the guideline premium/cash value corridor test, a fixed mandated corridor is possible (and exists under section 7702). In this case the guaranteed mortality rates for each age after omega presumably will be 100%, resulting in a guaranteed mortality charge exactly equal to the net amount of risk after omega. Forcing a positive net amount at risk at very high ages could result in the policy holder not being able to maintain the policy until death if guaranteed charges are incurred.

### **The IRS’s perceived concern that section 7702 would allow for contracts to be issued at very old ages with no amount at risk at issue**

The Notice would adversely affect policies that have been in force for many years in compliance with section 7702 and 7702A. By actuarial design, as these policies approach age omega, the cash value approaches the death benefit. There is no planned abuse or inherent unwarranted tax benefits for the few policyholders who survive to age 100. Mandating a corridor for policies that have been in compliance for many years does not serve the public’s interest in pre-funding their death benefit needs.

The taxing authorities have expressed concern over potentially abusive situations where it would be anticipated and planned to have no net amount at risk at issue, or when it is anticipated and planned at a policy’s inception that very quickly after issue any net amount at risk would be eliminated. This could only occur at very high issue ages close to the table’s omega or at age 95 for contracts that mature or endow by the terms of the contract at an age earlier than omega. If

this occurred, the policy would have no amount at risk immediately or within a short time after issue.

We are not aware of any policies that are currently issued at such high ages or if such policies can legally be issued. Consequently, this is a purely theoretical issue. If this situation becomes a critical deficiency of introducing a mortality table with a high age omega, the Work Group would be pleased to work with the IRS to develop a reasonable safe harbor that is actuarially appropriate. An example of such a safe harbor is to introduce a high issue age limit to the suitability of the 7702 and 7702A test.<sup>5</sup> Since the Code already recognizes a seven-year period of risk in the MEC rules, it might be possible to develop a safe harbor reflecting this seven-year period. For example, a safe harbor would apply only to contracts newly issued at least seven years before the later of age 95 or the age that the factor that is used to determine the minimum death benefit converges to one. Under this approach, the traditional whole life contract illustrated in the attached example could use the safe harbor as long as it was issued before age 114 (i.e., seven years before the later of 95 or 121). Exchanges designed to defeat the purpose of this rule could be prohibited. In this manner the real potential source of abuse is minimized, without introducing artificial, disruptive corridors at ages over 100.

## **Conclusion**

The Work Group appreciates the opportunity to comment on the actuarial issues raised in Notice 2009-47, and welcomes the opportunity to discuss with the IRS our comments in more detail on these issues.

Sincerely,

Barbara R. Gold  
Chair, Tax Work Group, Life Practice Council  
American Academy of Actuaries

CC: Donald J. Drees, Jr., Internal Revenue Service  
Sheryl Flum, Internal Revenue Service  
Mark S. Smith, Office of Tax Policy, Department of Treasury

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<sup>5</sup> The Work Group interprets current tax law as not requiring any net amount at risk above attained age 95. Similarly, we believe that this described example may also not be consistent with the requirements of existing law, but offer the approach solely as an example of an actuarially appropriate solution to a possible perception of an abuse.

Appendix A

<b>Paid-Up Traditional Whole Life Insurance                      Maximum Implied Cash Value Accumulation Test                      Corridor Factors for 2001 CSO tables allowed under                      Standard Nonforfeiture Law</b>		
<b>Attained</b>	<b>Male</b>	<b>Female</b>
<b>Age</b>	<b>Composite</b>	<b>Composite</b>
95	112.99%	116.39%
96	112.34%	115.42%
97	111.73%	114.65%
98	111.16%	113.93%
99	110.64%	113.10%
100	110.17%	112.27%
101	109.75%	111.48%
102	109.34%	110.74%
103	108.94%	110.04%
104	108.56%	109.38%
105	108.18%	108.79%
106	107.82%	108.25%
107	107.47%	107.76%
108	107.13%	107.32%
109	106.81%	106.92%
110	106.50%	106.56%
111	106.19%	106.24%
112	105.91%	105.95%
113	105.63%	105.67%
114	105.36%	105.38%
115	105.11%	105.12%
116	104.86%	104.88%
117	104.63%	104.65%
118	104.41%	104.44%
119	104.20%	104.25%
120	104.00%	104.00%
121	100.00%	100.00%
and over	100.00%	100.00%

**Assumptions:**

**Age Last Birthday, Claims paid at end of policy year,  
 4% interest**

**Percentages rounded up to 2 decimal places**

Appendix B

<b>Paid-Up Traditional Whole Life Insurance</b>		
<b>Maximum Implied Cash Value Accumulation Test</b>		
<b>Corridor Factors for 2001 CSO tables allowed under</b>		
<b>Standard Nonforfeiture Law</b>		
<b>Attained</b>	<b>Male</b>	<b>Female</b>
<b>Age</b>	<b>Composite</b>	<b>Composite</b>
95	110.79%	114.13%
96	110.16%	113.18%
97	109.56%	112.43%
98	109.00%	111.71%
99	108.49%	110.90%
100	108.03%	110.09%
101	107.62%	109.32%
102	107.22%	108.59%
103	106.83%	107.90%
104	106.45%	107.26%
105	106.08%	106.68%
106	105.73%	106.15%
107	105.38%	105.67%
108	105.05%	105.24%
109	104.74%	104.84%
110	104.43%	104.49%
111	104.13%	104.17%
112	103.85%	103.89%
113	103.58%	103.62%
114	103.32%	103.33%
115	103.07%	103.08%
116	102.83%	102.84%
117	102.60%	102.61%
118	102.38%	102.42%
119	102.18%	102.22%
120	101.99%	101.99%
121	100.00%	100.00%
and over	100.00%	100.00%

**Assumptions:**

**Age Last Birthday, immediate payment of claims, 4% interest**

**Percentages rounded up to 2 decimal places**