The 2001 CSO Mortality Table

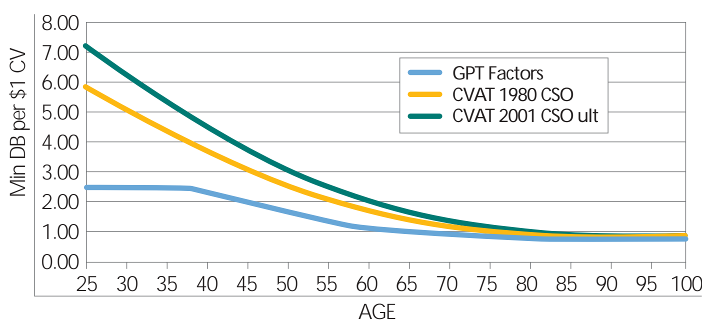
It's Not Just for Valuation and Nonforfeiture

AFTER MORE THAN TWO DECADES as the standard mortality table for valuation and nonforfeiture, the 1980 Commissioners Standard Ordinary table (CSO) is being replaced by a new standard—the 2001 CSO table.

With a multitude of changes in the insurance industry, along with the magnitude of change in both insured and population mortality over the past 20 years, the need for this new table was evident. But the need isn't only for valuation and nonforfeiture. In addition, the Internal Revenue Service and the U.S. Treasury have generated pressure to update "reasonable" mortality standards for life insurance taxation.

Section 7702 of the Internal Revenue Code places limits on the investment orientation of life insurance, either by restricting the allowable premium paid into a life insurance contract or by mandating minimum death benefits, or both. It also places restrictions on the assumptions underlying the calculation of these limits.

With respect to mortality, the tax law allows the use of "reasonable mortality" in computing these limitations, and specifies the prevailing CSO table as an upper limit on reasonable mortality. Thus, the transition to the new 2001 CSO as the prevailing table will affect the definition of life insurance calculations under Section 7702 and modified endowment contract (MEC) testing under Section 7702A, generally reducing the investment orientation of life insurance.



Given this impact, there are three principal issues all companies will need to address in implementing the new table in compliance with Sections 7702 and 7702A:

- When is the appropriate time to make the transition to the 2001 CSO table for computing the Section 7702 and 7702A limits?
- How will the 2001 CSO table affect both the premium limitations of Section 7702 and 7702A and the minimum death benefit requirements of Section 7702?
- What are the appropriate calculation rules for determining guideline, net single, and seven-pay premiums, particularly for contracts maturing beyond age 100?

Transition to the Prevailing Table

With the adoption of a new CSO table, a number of transitional questions need to be answered. At the time the reasonable mortality standards were imposed on the insurance industry in October of 1988, the prevailing 1980 CSO table was made mandatory in all states in just 10 weeks, so there was very little need for transition rules.

As long as companies were computing the appropriate definitional limits imposed by Section 7702 using 100 percent of the 1980 CSO table, little needed to be changed.

This time around, companies could use some guidance in the transition, once the 2001 CSO becomes the prevailing table. If the NAIC approves the model regulation later this year, the "permitted date" for using the new table for valuation and nonforfeiture could be as early as Jan. 1, 2003. The "required date" for using the new table for valuation and nonforfeiture is scheduled to be Jan. 1, 2008.

Under the rules of Section 807, which defines tax reserves for life insurance, the 2001 CSO table will become prevailing once it's permitted in 26 states. This will occur sometime between the permitted date and the required date. Three years after it becomes prevailing, it will become the required table for calculating tax reserves under Section807(d)(5)(B).

The problem lies in these overlapping and conflicting time frames. The 2001 CSO table will become the prevailing table for tax purposes before some states have adopted it for valuation and nonforfeiture purposes. Even in those states that are early to adopt the new table, insurers may elect to continue issuing contracts up until

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Test Premium	Ratio of 2001 CSO to 1980 CS Values Male	Female
GSP	75% to 85%	75% to 90%
GLP—Option 1	75% to 85%	80% to 85%
7-Pay	80% to 85%	85% to 90%

GLP—Option 2	Ratio of 2001 CSO to 1980 CS Values Male	Female
Endowment @ 95	75% to 80%	70% to 75%
Endowment @ 120	150% to 160%	155% to 170%

the required date with nonforfeiture and mortality guarantees based on the 1980 CSO table.

On its surface, Section 7702(c)(3)(B)(i) appears to require that mortality charges used in the calculation of the definitional limits under Section 7702 not exceed the 2001 CSO table once it becomes the prevailing table under Section 807(d)(5). This is likely to occur in 2005, if not sooner.

It's unclear whether the three-year transition period specified in Section 807(d)(5)(B) applies to Section 7702 and 7702A. This would certainly help in the transition to the new prevailing table, as it would require the use of the 2001 CSO table by Jan. 1, 2008 (assuming the table becomes the prevailing table on Jan. 1, 2005).

However, using the 2001 CSO table for purposes of Section 7702(c)(3)(B)(i), once it becomes the prevailing table, will make it difficult for companies to issue contracts in states that are slow to adopt the 2001 CSO table. In these states, it may be difficult to meet the nonforfeiture requirements (based on the 1980 CSO table) while at the same time satisfying the Section 7702 requirements (based on the 2001 CSO table).

This confusion is the unfortunate consequence of creating state law minimums (nonforfeiture values) that exceed federal maximums (funding limits) for some product designs. This will be particularly true for traditional contracts designed to comply with the cash value accumulation test of Section 7702(a)(1), where the test mandates maximum cash values for a given death benefit that would be less than state law minimums.

Smoothing the Conflict

Regulations may be needed to avoid this potential state/federal law conflict. Such regulations should address the need for a transition period during which the 1980 CSO table would continue to be reasonable mortality despite the fact that the2001 CSO table has become the prevailing table. This period would ideally extend to the NAIC required date in order to prevent the conflict of state and federal laws.

Further tension will also exist between the use of the 1980 CSO table and the 2001 CSO table in those states that have adopted the 2001 CSO table before it becomes the prevailing table. Companies electing to issue contracts based on the 2001 CSO table may find that their contracts are less competitive than similar contracts based on the 1980 CSO table—because the Section 7702 and 7702A limits are generally 10 percent to 20 percent higher under the 1980 CSO table. Marketing focus and product strategy will most likely dictate when companies decide to transfer their portfolio of products over to the 2001 CSO table.

Funding Limitations and Minimum Death Benefits

Section 7702 uses two tests to determine whether a contract is in fact life insurance for tax purposes. The plan design underlying a life insurance contract will generally determine which of the two tests to apply.

In theory, the cash value accumulation test is intended to apply to traditional whole life insurance contracts, while the guideline premium/cash value corridor test is intended to apply to universal life insurance contracts. The cash value accumulation test and the guideline premium/cash value corridor test involve complex actuarial computations that limit the allowable premiums and/or cash values permissible in a qualifying life insurance contract. The purpose of these tests is to restrict life insurance tax benefits to plans that aren't considered abusive in terms of their investment orientation. The rules under Section 7702 impose a significant compliance burden on the life insurance industry to assure that its products are treated as life insurance contracts under the Internal Revenue Code.

In practice, however, both tests have been applied to both traditional and universal life-type policies. As expected, the new CSO table will have an impact on policies under both tests. But the magnitude of the impact will vary. The guideline premium/cash value test allows a policy to have more investment orientation in the later policy years than a comparable policy tested under the cash value accumulation test. This impact will be magnified under the 2001 CSO table.

Premium Limitation under Section 7702 and 7702A

The guideline premium/cash value corridor test is a two-part test that must be satisfied at all times. The guideline premium portion of the test limits the premium that can be paid into the life insurance contract.

Similarly, the seven-pay test of Section 7702A defines a modified endowment contract. A–MEC is a life insurance contract where premium has exceeded the 7-pay limit, which is generally less than the guideline limit. As expected, the 2001 CSO table will serve to generally reduce the funding limitations imposed by Section 7702 and 7702A. This will further limit the investment orientation of most life insurance contracts.

In general, both guideline and seven-pay premiums are going to be 10 percent to 25 percent lower using the ultimate form of the 2001 CSO table. The one possible exception comes with option 2 death benefit contracts, where the resulting guideline level premium increases by more than 50 percent, provided the deemed maturity is extended to age 120. (Whether this is allowed under the statute is discussed in a separate section below.)

As expected, using the select and ultimate version of the 2001 CSO table will

further reduce funding limits. The premium limits using the select and ultimate table are generally 0 percent to 3 percent lower than those generated from using the ultimate table at younger issue ages and range from 7 percent to 12 percent lower at the older issue ages.

Minimum Death Benefit

The cash value corridor requirement of the guideline premium test is satisfied if the death benefit (as defined in Section 7702(f)(3)) under the contract at any time is at least equal to the applicable percentage (as set forth in Section 7702 (d)) of the cash surrender value of the contract. Because the applicable percentages are "hard-coded" into the statute, the transition to the 2001 CSO table won't have any impact on the corridor requirements imposed under the guideline premium test.

The cash value accumulation test is satisfied as long as the cash surrender value is less than the net single premium required to fund the future benefits guaranteed in the contract. Because this test isn't based on predetermined percentages like the guideline test, transition to the new 2001 CSO table will increase the minimum death benefit requirements imposed by the cash value accumulation test. For a given cash value (on a contract using the cash value accumulation test), the minimum required death benefit will increase by 10 percent to 20 percent, with the percentage difference decreasing as ages increase.

There are several characteristics of the 2001 CSO table that distinguish it from prior CSO tables, most notably a 25-year select period and the extension of the table beyond age 100. Because the 2001 CSO table extends to age 120, it's likely that companies will be developing contracts with maturity dates beyond age 100. This will raise some fundamental questions regarding how such contracts should be administered under the Section 7702 tests.

- Can benefits beyond age 100 be reflected in the calculation of test premiums?
- Is the application of the guideline premium test limited by the assumptions underlying the calculation of the premiums themselves?
- Can a company assume the Section 7702(d) corridor factors extend to age 120?
- How should the cash value accumulation test be administered beyond age 100?

Many of these questions are linked to the computational rules of Section 7702(e)(1)(B), which limit the future benefits that can be incorporated into the calculation of guideline and net single premiums. In particular, there are four computational rules that apply in the determination of guideline and net single premiums:

- Rule No. 1. In Section 7702(e)(1)(A), the death benefit is assumed not to increase.
- Rule No. 2. Section 7702(e)(1)(B) pro-

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vides that the maturity date assumed in the calculations can be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100.

- Rule No. 3. Section 7702(e)(1)(C) provides that death benefits are assumed to be provided until the "deemed" maturity date.
- Rule No. 4. Section 7702(e)(1)(D) states that the amount of any endowment benefit (or sum of endowment benefits) taken into account in the calculation cannot exceed the least amount payable as a death benefit at any time under the contract. The endowment benefit includes any cash surrender value on the deemed maturity date.

The computational rules themselves weren't designed to restrict the actual policy provisions but only to limit the assumptions that may be used in computing the limitation. According to the Joint Committee on Taxation Staff (DEFRA Bluebook, Page 654):

These rules restrict the actual provisions and benefits that can be offered only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation test) or the allowable funding pattern (under the guideline premium test). By prescribing computational assumptions, Congress limited the investment orientation of contracts while avoiding the regulation of the actual terms of insurance contracts.

While it's clear the intent of Congress wasn't to regulate the terms of insurance contracts, it may end up doing so. By placing a limiting age on the determination of future benefits, it becomes less clear as to how to administer contracts with extended maturity under Sections 7702 and 7702A. Companies may react by restricting maturity dates to age 100 and using extended maturity riders as a way of dealing with the issue, unless changes are allowed to accommodate the characteristics of the 2001 CSO table.

Extending the endowment age to 120 will have a limited effect on the investment orientation of most life insurance contracts, as guideline single, net single, and seven-pay premiums will be marginally less than their endowment-age-100 counterparts at most ages. The one noticeable difference can arise in an option 2 guideline level premium, where the guideline level premium can increase by as much as 50 percent to 75 percent when the endowment age is extended to 120.

There are certainly common-sense approaches for accommodating the 2001 CSO table for tax purposes. Simply using the actual maturity date of the contract (to the extent it's beyond age 100) as the deemed maturity date under Section 7702(e)(1)(B) makes many of these problems go away. Although simple in design and consistent with congressional intent, it may not be feasible without legislation.

Conclusion

As adoption of the new 2001 CSO table draws closer, discussions surrounding its use for Sections 7702 and 7702A testing will increase. The insurance industry will be looking for guidance through transition rules, safe harbors, and clarification of the application of the deemed maturity provisions in Section 7702(e)(1)(B) and (C). Whether such guidance will emerge remains to be seen. What's clear is that the trend that began back in 1982 to reduce funding limits will continue with the transition to the new CSO table.

Given this, the insurance industry will need to exercise some caution in resolving these issues. While it's hoped the IRS will issue guidance in the form of transition rules and safe harbor provisions for the 2001 CSO table, another possible approach for dealing with these issues is through legislation.

Once a decision is made to open up Section 7702 for legislative changes, however, there's no guarantee that the changes will be limited simply to those relating to the new CSO table. Other more fundamental changes may be sought to further restrict the investment orientation of life insurance, an outcome that would certainly be detrimental to the insurance industry and its customers. ●

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