INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 15, 2003

Number: **200416009**
Release Date: 4/16/04

Third Party Contact:
Index (UIL) No.: 807.03-04
CASE-MIS No.: TAM-164435-03/CC:FIP:B4

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Years Involved:

LEGEND:

Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Event X =

Y =

ISSUE:

Whether the Taxpayer incurred certain risks in connection with its immediate and supplementary annuity contracts that were not taken into account in computing the applicable prevailing commissioners' standard mortality table and, therefore, Taxpayer properly adjusted that table to take such risks into account in accordance with § 807(d)(2)(C)?

CONCLUSION:

The risks incurred by Taxpayer in connection with its immediate and supplementary annuity contracts 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." Section 807(d)(2) requires the use of the mortality table applicable as of the contract date and Taxpayer improperly adjusted that table to take such risks into account.

FACTS:

According to the facts presented, the Taxpayer is a mutual life insurance company within the meaning of § 816(a) and is taxed under the provisions of Part I of subchapter L. Taxpayer issues life insurance and annuity contracts, including immediate life annuities and life annuities selected under supplementary contracts with life contingencies. In Date 1, the Taxpayer changed its method of determining the interest rate component of annuity premiums by changing the interest rates on a more frequent basis: weekly for immediate annuities and biweekly for supplementary contracts. The Taxpayer implemented this change in order to make its pricing more competitive.

Different mortality tables are used for annuities than are used for measuring life insurance risk. Prior to 1999, the appropriate annuity mortality table for Taxpayer's annuity contracts in question contracts was the 1983 Annuity Table *a*. For contracts issued in 1999, reserves are computed using the Annuity 2000 Table that was first permitted to be use in 1999. The annuity tables reflect lower mortality rates. Annuity contracts are not generally underwritten and, therefore, the insurance company does not know in advance whether or not the policyholder is healthy. However, as a result of self-selection, healthier people are more likely to purchase annuities and sicker people are more likely to purchase life insurance. Thus, annuitants have lower mortality than the population at large and still lower mortality than the population of life insurance purchasers. The association of healthier people with annuity purchases erodes somewhat over the life of the contract. That is, policyholders age 65 who purchase annuities at that age tend to have lower mortality than policyholders age 65 whose annuities are ten years old. Annuitants in general are also likely to be wealthier and more highly educated than the general population. These lower mortality factors are taken into account in the annuity tables.

The 1983 Annuity Table *a* (Table *a*) incorporated a 10% "loading factor" or margin for lower mortality. According to a 1995 article in Transactions, a publication of the Society of Actuaries, by Robert L. Johansen, "Review of Adequacy of 1983 Individual Annuity Mortality Table", Volume XLVII, p. 211, 217, "[t]he 10% loading in 1983 Table *a* was not intended to provide a margin for future mortality improvement; rather, it provides a margin for companies that experience lower-than-average annuitant mortality." This article concludes that as a result of mortality improvement between 1983 and 1995, a new table will have to be developed.

In Date 2, the Taxpayer's actuaries developed a study of its annuitant mortality experience. It considered policies between Date 3 and Date 4, excluding Event X it considered an anomaly. The Taxpayer determined that its mortality was less than that reflected in Table *a* , with percentages depending on contract age, and that overall mortality was improving at a rate of Y% per year. While the study did not analyze the annuitant pool to determine the specific causes of this lower mortality, the mortality study demonstrated an abrupt improvement in early duration mortality when comparing contracts issued since Date 1 to those contracts issued earlier. The Taxpayer observed that the timing of this abrupt improvement in mortality corresponded to the introduction of the new method of determining interest rates for these contracts.

As a result of the study, starting in Date 2, the Taxpayer adjusted Table *a* for its own experience by decreasing the mortality assumptions built into Table *a* by various percentages depending on age and contract duration. The Taxpayer also applied a Y% per year mortality improvement assumption to Table *a*. In addition to this modification, the Taxpayer's actuaries removed the 10% loading component from Table *a*. The Taxpayer's actuaries reasoned that since they were using their own experience as a basis for adjusting the table, including the Y% improvement factor, it was unnecessary to include the 10% load.

In Date 2, the Taxpayer also modified the mortality assumptions in its pricing formulas for immediate annuities and supplementary contracts issued in Date 2 and later. The increased mortality risk was reflected in the form of higher premiums on its contracts.

The Taxpayer changed its method of computing reserves for all of the immediate annuities and supplementary annuity contracts in force as of Date 2 by this change in its mortality tables, for both statutory and tax. For tax purposes, it implemented the change in method for new contracts issued in Date 2, and as a § 807(f) adjustment for contracts issued prior to Date 2.

LAW AND ANALYSIS:

The computation of reserve deductions with respect to life insurance, annuity, and noncancellable and guaranteed renewable accident and health insurance contracts is subject to the rules set out in § 807 of the Internal Revenue Code.

Section 805(a)(2) authorizes a deduction with respect to the net increase in certain reserves required by § 807(c) to be taken into account. Under § 807(c)(1), the reserves to which this treatment applies include "life insurance reserves as defined in § 816(b)."

Section 807(d)(1) provides that, other than for purposes of § 816 (relating to qualification as a life insurance company), the amount of the life insurance reserve with respect to any contract is the greater of (i) the net surrender value of the contract, or (ii) the reserve determined under § 807(d)(2). In no event may the reserve for any contract exceed the amount taken into account with respect to that contract as of that time in determining the statutory reserves (reduced by any deferred and uncollected premiums taken into account in determining the statutory reserves). Section 807(d)(1) (flush language); see also §§ 809(b)(4)(B) and 811(c).

Section 807(d)(2) provides that the reserve for any contract must be determined by using:

> (A) the tax reserve method applicable to such contract,
> (B) the greater of—
>   (i) the applicable Federal interest rate, or
>   (ii) the prevailing State assumed interest rate, and
> (C) 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.

See § 10241 of the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, for amendments to § 807 applicable to contracts issued in taxable years beginning after December 31, 1987.

Section 807(d)(5)(A) provides that the term "prevailing commissioners' standard tables" means, "with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued."

The legislative history relating to § 807(d)(2)(C) states as follows:

> 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, adjustment 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.

H.R. Rep. No. 4170, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 603 (Comm. Print 1984). (footnote omitted); *see also*, H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1416 (1984); 1 S. Rpt. No. 169, 98th Cong., 2d Sess. 542 (1984.

As reflected in the examples provided, 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." However, based on a report of the committee that drafted Table *a,* decreased mortality was taken into account. Noting that "[t]here can be no doubt that there has been a substantial drop in mortality", the committee expressed concern that the original 1983 Basic Table may not have accurately reflected the improvement in mortality because the calculations were based on census data later revised. The committee wanted to ensure that the substantial decrease in mortality was taken into account in the table and adopted a 10% loading margin` to address that concern. As stated in the Transactions of Society of Actuaries, "Report of the Committee to Recommend a New Mortality Basis for Individual Annuity Valuation (Derivation of the 1983 Table *a*)", vol. 33 (1981):

> To provide a safe mortality table for valuation purposes, it is necessary to provide a margin over the experience rates. The purpose of the margin may be defined variously as providing for variations in mortality levels by company, variations between different types of contract…and different levels of mortality because of variations in a company's mix of business, fluctuations in mortality from year to year, and … a future decrease in mortality of annuitants…
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> *   *   *
>
> The committee finally rejected any variation by age, noting that the primary reason for the loading was to cover variations in mortality between companies. A secondary purpose of the loading is to provide for variations in mortality from year to year.

"Report of the Committee to Recommend a New Mortality Basis for Individual Annuity Valuation (Derivation of the 1983 Table *a*")", Transactions of Society of Actuaries, vol. 33, pp. 691, 702 (1981),

Thus, Table *a* incorporated the 10% loading factor specifically to address the risks incurred by the Taxpayer. In order to adjust Table *a,* the Taxpayer must show that its policyholders have risk characteristics that differ from the typical risk characteristics of the population measured by Table *a* (the examples being poor health, living in a dangerous country, not underwritten) and that Table *a* does not take these atypical risk characteristics into account. Being in poor health, living in a dangerous country, or not being required to provide evidence of insurability are all risk factors which would make it more likely that the policyholder would experience greater mortality than is assumed in the tables. 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.

As indicated above, the actuarial tables for immediate annuities assume that the population of annuitant policyholders is healthier than that of the population at large, and further allow for companies with significantly lower mortality. Thus, the risks being modified by the Taxpayer were already taken into account in Table *a*. It is significant that the Taxpayer, in adjusting Table *a* for its own experience, eliminated the 10% load built into the Table. This shows that the taxpayer did not adjust Table *a* for a risk not taken into account.; rather, it adjusted Table *a* because it believed the risk was not properly valued by the Table.

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." Section 807(d)(2) requires the use of the mortality table applicable as of the contract date and Taxpayer improperly adjusted that table to take such risks into account.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.