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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

26 CFR Part 1

[REG-248110-96]

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Guidance Under Section 817A Regarding Modified Guaranteed Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations affecting insurance companies that define the interest rate to be used with respect to certain insurance contracts that guarantee higher returns for an initial, temporary period.

Specifically, the proposed regulations define the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts. The proposed regulations also address how temporary guarantee periods that extend past the end of a taxable year are to be taken into account. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 20, 2002.

Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for August 27, 2002, at 10 a.m., must be received by August 6, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-248110-96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG-248110-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at: <http://www.irs.gov/regs>. The public hearing will be held in Room 4718, 1111 Constitution, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Ann H. Logan, 202-622-3970. Concerning the hearing, LaNita Van Dyke of the Regulations Unit, 202-622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

History

Section 817A was added by section 1612 of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755. Section 817A is effective for taxable years beginning after December 31, 1995. See Small Business Job Protection Act section 1612(c)(1).

Previous guidance on the matters addressed by these proposed regulations is provided in Notice 97-32 (1997-1 C.B. 420), which specifies the appropriate interest rate to be used during the temporary guarantee period of modified guaranteed contracts. Generally, the specified rate is the greater of the interest rate assumed by the insurance company to determine future guaranteed

benefits or Moody's Corporate Bond Yield Average-Monthly Average Corporates (Moody's rate). For equity-indexed modified guaranteed contracts whose market value adjustment is based on the performance of stocks, other equity instruments or equity-based derivatives, the specified rate is obtained by multiplying whichever of the two rates is greater by 1.1. Notice 97-32 was to be effective pending the publication of further guidance. Comments received after publication of the Notice indicated the need for further consideration of the appropriate rate to be used.

Interest Rates Affecting Modified Guaranteed Contracts

These proposed regulations govern the interest rate to be used when life insurance companies issue certain modified guaranteed annuity and life insurance contracts. A modified guaranteed contract temporarily guarantees a higher return than the permanently guaranteed crediting rate, in exchange for shifting additional investment risk to the policyholder in the form of a market value adjustment. The temporary guarantee may be a rate based on stocks, other equity instruments, or equity-based derivatives (equity-indexed modified guaranteed contracts) or a rate that is not related to equity performance (non-equity-indexed modified guaranteed contracts) or a rate based on bond or equity yields (equity-indexed modified guaranteed contracts). During the temporary guarantee period, the amount paid to the policyholder upon surrender is increased or decreased by a market value adjustment, which is determined by a formula in the modified guaranteed contract. Modified guaranteed contracts can

be issued out of a life insurance company's general account or one or more segregated accounts.

Section 817A provides special tax treatment for certain modified guaranteed contracts issued out of a segregated account. For this purpose, the term modified guaranteed contract is defined as an annuity, life insurance, or pension plan contract (other than a variable contract described in section 817) under which all or part of the amounts received under the contract are allocated to a segregated account. Assets and reserves in this segregated account must be valued from time to time with reference to market values for annual statement purposes. Further, a modified guaranteed contract must provide either for a net surrender value or for a policyholder's fund (as defined in section 807(e)(1)). If only a portion of a contract is not described in section 817, such portion is treated as a separate contract for purposes of applying section 817A.

The tax reserves for a modified guaranteed contract are computed under either sections 807(c)(3) or (d)(2), depending upon whether the reserves are also life insurance reserves as defined by section 816(b). If the reserves are not life insurance reserves, section 807(c)(3) provides that reserves for obligations under insurance and annuity contracts not involving life, accident, or health contingencies are computed using an appropriate rate of interest. The appropriate rate of interest is the highest (as of the time the obligation first did not involve life, accident, or health contingencies) of the following rates: (1) the applicable Federal interest rate (as defined in section 807(d)(2)(B)(i)); (2) the prevailing State assumed interest rate (as defined in section 807(d)(2)(B)(ii)); or

(3) the rate of interest assumed by the insurance company to determine the contract's guaranteed benefit. Section 807(c) also provides that the reserves computed under section 807(c)(3) are never less than the net surrender value of the contract.

For a modified guaranteed contract that does give rise to life insurance reserves, as defined in section 816(b), reserves are computed under section 807(d). Under section 807(d)(1), the life insurance reserves for a contract cannot exceed the statutory reserves for the contract. Subject to that cap, a contract's life insurance reserves equal the greater of: (1) the contract's net surrender value; or (2) the contract's Federally prescribed reserve determined under section 807(d)(2).

Section 807(d)(2) provides that the Federally prescribed reserves for a contract are determined using: (1) the tax reserve method applicable to the contract; (2) the greater of the applicable Federal interest rate or the prevailing State assumed interest rate in effect on the date of the issuance of the contract; and (3) the prevailing commissioners' standard tables for mortality and morbidity.

In the case of a life insurance contract covered by the Commissioners' Reserve Valuation Method (CRVM) or an annuity contract covered by the Commissioners' Annuities Reserve Valuation Method (CARVM), section 807(d)(3) provides that the tax reserve method applicable to a contract is the CRVM or CARVM prescribed by the National Association of Insurance Commissioners (NAIC), which is in effect on the date of the issuance of the contract.

Section 811(d) imposes an additional reserve computation rule for contracts that guarantee beyond the end of the taxable year payment or crediting of amounts in the nature of interest in excess of the greater of the prevailing state assumed interest rate or the applicable Federal interest rate. In those circumstances, section 811(d) requires that the contract's future guaranteed benefits be determined as though the interest in excess of the greater of the prevailing state assumed interest rate or the applicable Federal rate were guaranteed only to the end of the taxable year.

Required Interest

Section 812(b) defines the company's share of net investment income for the taxable year the computation of which also requires use of an interest rate. The company's share equals the excess, if any, of the net investment income over the sum of the policy interest (as defined in section 812(b)(2)) and the gross investment income's proportionate share of policyholder dividends (as defined in section 812(b)(3)) for the taxable year. Policy interest includes required interest on reserves under section 807(c) (other than section 807(c)(2) reserves), determined under section 812(b)(2)(A) by using the greater of the prevailing State assumed rate or the applicable Federal interest rate. If neither the prevailing State assumed interest rate nor the applicable Federal interest rate is used, another appropriate rate is used to calculate required interest.

Legislation Affecting Modified Guaranteed Contracts

The interest rates used for both reserves and required interest for modified guaranteed contracts are governed by section 817A. Under section

817A(e)(2), the IRS is authorized to determine annually the applicable interest rate to be used under sections 807(c)(3), 807(d)(2)(B) and 812 for a modified guaranteed contract. The IRS is authorized to exercise this authority by issuing a periodic announcement of the appropriate market interest rates or formula for determining such rates. H.R. Conf. Rept. No. 737, 104th Cong. 2d Sess. 313 (1996). Section 817A(e) also authorizes the IRS to modify or waive the application of section 811(d) (relating to interest guaranteed beyond the end of the taxable year), and to prescribe other regulations that are necessary or appropriate to carry out the purposes of section 817A.

The legislative history of section 817A indicates that an appropriate interest rate is a current market rate. H.R. Conf. Rep. No. 737, at 313. The interest rate may be determined, for example, using either a rate that is appropriate for the obligations under the contract to which the reserve relates or the yield on the assets underlying the modified guaranteed contract. In light of this legislative history and the purpose of section 817A, the statutory grant of authority to prescribe regulations to specify the appropriate interest rate is broad, granting discretion to the Secretary to determine that rate which will best match the obligations under modified guaranteed contracts to the market fluctuations of the underlying assets.

EXPLANATION OF PROVISIONS

This document contains proposed amendments to 26 CFR part 1 under sections 807, 811, 812, and 817A of the Internal Revenue Code (Code). These proposed rules specify the appropriate interest rates to be used by insurance companies in the determination of tax reserves under sections 807(c)(3) and (d)(2)(B), and the company's share of net investment income under 812(b)(2)(A), for certain modified guaranteed contracts, as defined in section 817A(d). It also describes the manner in which section 811(d) governing the calculation of reserves for certain insurance contracts is to be applied to these contracts. The proposed regulations do not adopt the position set forth in Notice 97-32, and instead provide that the appropriate interest rate for each non-equity-indexed modified guaranteed contract is the current market rate. These proposed regulations define the current market rate as the Treasury constant maturity interest rate published by the Board of Governors of the Federal Reserve System. The Treasury constant maturity interest rates are released each Monday as part of statistical release H.15, Selected Interest Rates, and can also be found at <http://www.federalreserve.gov/releases/#weekly>. Availability of the release is announced on (202) 452-3206. The proposed regulations do not take a position as to the appropriate interest rate to be used for an equity-indexed modified guaranteed contract whose market value adjustment is based on the performance of stocks, other equity instruments or equity-based derivatives.

The proposed regulations under section 817A, relating to the definition of the appropriate interest rate to be used in determining tax reserves under sections 807(c)(3) and (d)(2), the appropriate interest rate to be used under section 811(d), and required interest under 812(b)(2)(A), will be effective on the date that the regulations become final. However, pursuant to section 7805(b)(7), taxpayers will be permitted to apply the final regulations retroactively for all tax years beginning after December 31, 1995, the effective date of section 817A.

Effect on Other Documents

Notice 97-32 will not be revoked or superseded until final regulations are published in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (preferably a signed original and eight copies) or electronic comments that are timely submitted to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

Comments are specifically requested on the use of a different current market rate for non-equity-indexed modified guaranteed contracts than the rate specified in these proposed regulations. Comments are also requested concerning the appropriate interest rate to use for equity-indexed modified guaranteed contracts. Any comments on these topics should address not only the definitions of such rates, but whether such approaches are presently in use among taxpayers, why such rates would produce superior measures of reserves and net income than the current market rate proposed in these regulations, and whether the use of such rates would produce simpler and less costly compliance burdens than the current market rate proposed in these regulations.

With regard to any comments submitted regarding non-equity-indexed modified guaranteed contracts that suggest the use of a insurer's contract crediting rate offered for newly issued contracts with temporary guarantee periods equal in duration to the remaining duration of the temporary guarantee period of the original contract, several additional questions should be addressed. In the event the insurer does not offer modified guaranteed contracts with an

identical temporary guarantee period as the temporary guarantee period remaining for the original contract, what rule should be used? If an interpolation of other rates should be used, what rule should be used? In the event interpolation is not meaningful because (1) the duration periods of the modified guaranteed contracts being newly issued are too dissimilar from the contract's remaining duration, (2) there are not enough newly issued modified guaranteed contracts to make a reasonable interpolation, or (3) the insurer has ceased issuing modified guaranteed contracts, what rule should be used? For example, should the federal rate defined in section 1272(d) applicable for the number of years remaining in the temporary guarantee period of the contract be used?

Comments may also be submitted requesting that section 811(d) be modified or waived regarding modified guarantee contracts. The requested waiver or modification should include details on the implementation of any proposed rules.

Finally, if the application of the regulation for earlier tax years, once made final, requires clarification or amplification, affected taxpayers should detail their concerns and proposed solutions. All comments will be available for public inspection and copying in their entirety.

A public hearing has been scheduled for August 27, 2002, at 10 a.m., in Room 4718 in the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors must enter at the main entrance, located at 1111 Constitution Avenue, NW. All visitors must present photo identification to enter the building and visitors will not be admitted beyond

the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments, an outline of the topics to be discussed, and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by August 6, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Ann H. Logan, Office of the Associate Chief Counsel (Financial Institutions and Products), Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER
31, 1953

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.807-2 also issued under 26 U.S.C. 817A(e) * * *

Section 1.811-3 also issued under 26 U.S.C. 817A(e) * * *

Section 1.812-9 also issued under 26 U.S.C. 817A(e) * * *

Section 1.817A-1 also issued under 26 U.S.C. 817A(e) * * *

Par. 2. Section 1.807-2 is added to read as follows:

§1.807-2 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and §1.817A-1(a)(1)), see §1.817A-1.

Par. 3. Section 1.811-3 is added to read as follows:

§1.811-3 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and §1.817A-1(a)(1)), see §1.817A-1.

Par. 4. Section 1.812-9 is added to read as follows:

§1.812-9 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and §1.817A-1(a)(1)), see §1.817A-1.

Par. 5. Sections 1.817A-0 and 1.817A-1 are added to read as follows:

§1.817A-0 Table of contents.

This section lists the captions that appear in section 1.817A-1:

§1.817A-1 Certain modified guaranteed contracts.

(a) Definitions.

- (1) Modified guaranteed contract.
- (2) Temporary guarantee period.
- (3) Equity-indexed modified guaranteed contract.
- (4) Non-equity-indexed modified guaranteed contract.
- (5) Current market rate for non-equity-indexed modified guaranteed contract.
- (6) Current market rate for equity-indexed modified guaranteed contract.

[Reserved.]

(b) Applicable interest rates for non-equity-indexed modified guaranteed contracts.

- (1) Tax reserves during temporary guarantee period.
- (2) Required interest during temporary guarantee period.
- (3) Application of section 811(d).
- (4) Periods after the end of the temporary guarantee period.
- (5) Examples.

(c) Applicable interest rates for equity-indexed modified guaranteed contracts.

[Reserved.]

(d) Effective date.

§1.817A-1 Certain modified guaranteed contracts.

(a) Definitions--(1) Modified guaranteed contract. The term modified guaranteed contract (MGC) is defined in section 817A(d) as an annuity, life insurance, or pension plan contract (other than a variable contract described in section 817) under which all or part of the amounts received under the contract are allocated to a segregated account. Assets and reserves in this segregated account must be valued from time to time with reference to market values for annual statement purposes. Further, an MGC must provide either for a net surrender value or for a policyholder's fund (as defined in section 807(e)(1)). If only a portion of a contract is not described in section 817, such portion is treated as a separate contract for purposes of applying section 817A.

(2) Temporary guarantee period. An MGC may temporarily guarantee a return other than the permanently guaranteed crediting rate for a period specified

in the contract (the temporary guarantee period). During the temporary guarantee period, the amount paid to the policyholder upon surrender is usually increased or decreased by a market value adjustment, which is determined by a formula set forth under the terms of the MGC.

(3) Equity-indexed modified guaranteed contract. An equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period based on the performance of stocks, other equity instruments, or equity-based derivatives.

(4) Non-equity-indexed modified guaranteed contract. A non-equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period not based on the performance of stocks, other equity instruments, or equity-based derivatives.

(5) Current market rate for non-equity-indexed modified guaranteed contracts. The current market rate for a non-equity-indexed MGC issued by an insurer (whether issued in that tax year or a previous one) is the appropriate Treasury constant maturity interest rate published by the Board of Governors of the Federal Reserve System for the month containing the last day of the insurer's taxable year. The appropriate rate is that rate published for Treasury securities with the shortest published maturity that is greater than (or equal to) the remaining duration of the current temporary guarantee period under the MGC.

(6) Current market rate for equity-indexed modified guaranteed contracts.

[Reserved]

(b) Applicable interest rates for non-equity-indexed modified guaranteed contracts--(1) Tax reserves during temporary guarantee period. An insurance company is required to determine the tax reserves for an MGC under sections 807(c)(3) or (d)(2). During a non-equity-indexed MGC's temporary guarantee period, the applicable interest rate to be used under sections 807(c)(3) and (d)(2)(B) is the current market rate, as defined in paragraph (a)(5) of this section.

(2) Required interest during temporary guarantee period. During the temporary guarantee period of a non-equity-indexed MGC, the applicable interest rate to be used to determine required interest under section 812(b)(2)(A) is the same current market rate, defined in paragraph (a)(5) of this section, that applies for that period for purposes of sections 807(c)(3) or (d)(2)(B).

(3) Application of section 811(d). An additional reserve computation rule applies under section 811(d) for contracts that guarantee certain interest payments beyond the end of the taxable year. Section 811(d) is not modified or waived for the taxable year in which a non-equity-indexed MGC is issued. The current market rate, as defined in paragraph (a)(5) of this section, is to be applied to the remaining years of the MGC's temporary guarantee period.

(4) Periods after the end of the temporary guarantee period. For periods after the end of the temporary guarantee period, sections 807(c)(3), 807(d)(2)(B), 811(d) and 812(b)(2)(A) are not modified when applied to non-equity-indexed MGCs. None of these sections are affected by the definition of current market rate contained in paragraph (a)(5) of this section once the temporary guarantee period has expired.

(5) Examples. The following examples illustrate this paragraph (b):

Example 1. (i) IC, a life insurance company as defined in section 816, issues a MGC (the Contract) on August 1 of 1996. Assume that the conditions invoking the application of section 811(d) are not present. The Contract is an annuity contract that gives rise to life insurance reserves, as defined in section 816(b). IC is a calendar year taxpayer. The Contract guarantees that interest will be credited at 8 percent per year for the first 8 contract years and 4 percent per year thereafter. During the 8-year temporary guarantee period, the Contract provides for a market value adjustment based on changes in a published bond index and not on the performance of stocks, other equity instruments or equity based derivatives. IC has chosen to avail itself of the provisions of these regulations for 1996 and taxable years thereafter. The 10-year Treasury constant maturity interest rate published for December of 1996 was 6.30 percent. The next shortest maturity published for Treasury constant maturity interest rates is 7 years. As of the end of 1996, the remaining duration of the temporary guarantee period for the Contract was 7 years and 7 months.

(ii) To determine under section 807(d)(2) the end of 1996 reserves for the Contract, IC must use a discount interest rate of 6.30 percent for the temporary guarantee period. The interest rate to be used in computing required interest under section 812(b)(2)(A) for 1996 reserves is also 6.30 percent.

(iii) The discount rate applicable to periods outside the 8-year temporary guarantee period is determined under sections 807(c)(3), 807(d)(2)(B), 811(d) and 812(b)(2)(A) without regard to the current market rate.

Example 2. Assume the same facts as in Example 1 except that it is now the last day of 1998. The remaining duration of the temporary guarantee period under the Contract is now 5 years and 7 months. The 7-year Treasury constant maturity interest rate published for December of 1998 was 4.65 percent. The next shortest duration published for Treasury constant maturity interest rates is 5 years. A discount rate of 4.65 percent is used for the remaining duration of the

temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

Example 3. Assume the same facts as in Example 1 except that it is now the last day of 2001. The remaining duration of the temporary guarantee period under the Contract is now 2 years and 7 months. The 3-year Treasury constant maturity interest rate published for December of 2001 was 3.62 percent. The next shortest duration published for Treasury constant maturity interest rates is 2 years. A discount rate of 3.62 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

(c) Applicable interest rates for equity-indexed modified guaranteed contracts. [Reserved.]

(d) Effective date. Paragraphs (a), (b) and (d) of this proposed regulation are effective on the date this notice is filed as a final regulation in the **Federal Register**. However, pursuant to section 7805(b)(7), taxpayers may elect to apply the final regulations retroactively for all taxable years beginning after December 31, 1995, the effective date of section 817A.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue.